88-1389

No. _____

In The

Supreme Court of the United States

October Term, 1988

H.J. FREEDE and JOSEPHINE W. FREEDE,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Tenth Circuit

PETITION FOR WRIT OF CERTIORARI

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April 25, 1989

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QUESTION PRESENTED

Whether for Federal income tax purposes amounts received by cash-basis taxpayers for excess payments under the "take or pay" provisions in a gas supply contract are to be treated as production payments within the meaning of Section 636(a) of the Internal Revenue Code or as income to the recipients.

RULE 28.1 LISTING

H.J. Freede and Josephine W. Freede

TABLE OF CONTENTS

Page

QUESTION PRESENTED i

RULE 28.1 LISTING i

TABLE OF AUTHORITIES iv

OPINIONS BELOW 2

JURISDICTION 2

CONSTITUTIONAL PROVISIONS, STATUTES AND RULES INVOLVED 2

STATEMENT OF THE CASE 2

A. The Trial Court Proceedings 4

B. The Court of Appeals Decision 4

REASONS FOR GRANTING THE WRIT 5

I. THE COURT OF APPEALS IMPROPERLY APPLIED THE DOCTRINE OF ECONOMIC INTEREST, AS PREVIOUSLY ESTABLISHED BY DECISIONS OF THIS COURT, TO TAKE OR PAY PAYMENTS. 5

A. If Allowed to Stand, This Decision is in Conflict With Prior Decisions of This Court Since It Improperly Applies This Court's Doctrine of 'Economic Advantage' to Take or Pay Contracts. 7

B. The Court of Appeal's Expansion of the Requirements Necessary for an Economic Interest to Include a Profit in Addition to a Return of Investment is Inconsistent With Prior Decisions of This Court. 11

C. The Determination of the Court of Appeals That OG&E's Excess Payments Cannot Properly be Viewed as Investments in the Gas Property is Inconsistent With Prior Decisions of This Court. 13

TABLE OF CONTENTS–Continued

Page

II. ASSUMING THAT THIS COURT'S PREVIOUS DECISIONS DO NOT FORECLOSE THE DECISION OF THE COURT OF APPEALS, THE COURT OF APPEALS HAS DECIDED AN IMPORTANT QUESTION OF FEDERAL LAW WHICH HAS NOT PREVIOUSLY BEEN DECIDED, WHICH DECISION SHOULD BE MADE BY THIS COURT..... 16

CONCLUSION..... 17

TABLE OF AUTHORITIES

Page

CASES

Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25 (1946) 12

Commissioner v. I.A. O'Shaughnessy, Inc., 124 F.2d 33 (10th Cir. 1941) 15

Commissioner v. Southwest Exploration Co., 350 U.S. 308 (1956) 7, 13

Dille v. Carter Oil Co., 192 F.2d 791 (10th Cir. 1951) 9

Greenshields v. Warren Petroleum Corp., 248 F.2d 61 (10th Cir. 1957) 14

Helvering v. Bankline Oil Co., 303 U.S. 362 (1938).. 8, 12

Kirby Petroleum Co. v. Commissioner, 326 U.S. 599 (1946) 12, 13

Palmer v. Bender, 287 U.S. 551 (1933) 4, 11, 13

Paragon Jewel Coal Co. v. Commissioner, 380 U.S. 624 (1965) 8

Rissler & McMurry Co. v. United States, 480 F.2d 684 (10th Cir. 1973) 8, 11, 12

Standard Oil Company of Texas v. Marshall, 265 F.2d 46 (5th Cir. 1959) 9

Utah Salt Co. v. Wise, 370 F.2d 976 (10th Cir. 1967) 8, 11, 12

REVENUE RULING

Revenue Ruling 66-64, 1966 C.B. 97 10

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On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Tenth Circuit

PETITION FOR WRIT OF CERTIORARI

Petitioners H.J. Freede and Josephine W. Freede ("Taxpayers") respectfully pray that a writ of certiorari issue to review the decision of the United States Court of Appeals for the Tenth Circuit (Circuit Judge Ebel, with Circuit Judges Moore and Barrett), which reversed a judgment for the Taxpayers based on a United States Tax Court decision.

OPINIONS BELOW

The opinion delivered in the Court of Appeals is reported at 864 F.2d 671 (10th Cir. 1988).

JURISDICTION

The judgment of the Court of Appeals was dated and entered November 1, 1988. Petitioners' timely petition for rehearing and suggestion for rehearing en banc was denied by the Court of Appeals on January 27, 1989. The panel judges, upon their own motion, revised their opinion in the same order. Robert S. Folsom and Mary M. Folsom, petitioners below in No. 86-2403, do not join in this petition for writ. The jurisdiction of this Court to review the judgment of the Court of Appeals by writ of certiorari is conferred by 28 U.S.C. §§1254(1), 2101(c).

CONSTITUTIONAL PROVISIONS, STATUTES AND RULES INVOLVED

26 U.S.C. §636(a) and 26 C.F.R. 1.636-3(a).

STATEMENT OF THE CASE

This case involves the proper treatment for federal income tax purposes of amounts received by the Taxpayers from Oklahoma Gas and Electric Company ("OG&E") under a "take or pay" provision in a gas supply contract for gas not taken by OG&E during the

year in question. Taxpayers own fractional working interests in various oil and gas leases in Oklahoma. In 1976, they entered into a take or pay gas purchase contract with OG&E. Under this contract, OG&E agreed to pay for a specified minimum quantity of gas each year, regardless of whether it took physical delivery of the gas. If the amount of gas paid for under the take or pay provision exceeded the amount of gas actually taken from Taxpayers' well, OG&E had the right to credit the excess amount in later years against gas taken in excess of the minimum contract quantity. However, OG&E would lose the benefit from any excess payments that it did not recoup by taking extra gas within the twenty-year term of the contract.

In 1979, OG&E made the minimum payment required by the contract but took less than the minimum contract quantity. Thus, a portion of the contractual payments that Taxpayers received from OG&E in 1979 represented payment for gas not actually taken in that year. At that time, the leases had sufficient projected reserves to enable OG&E to recoup the untaken gas in later years if it wanted to do so.

Although Taxpayers were on the cash, as opposed to accrual, method of accounting, they did not include as income the amounts received in 1979 for gas not taken that year. They maintained that OG&E's excess payments created "production payments" pursuant to I.R.C. §636(a), 26 U.S.C. §636(a), and therefore the payments should be treated for income tax purposes as if they were loans, with income recognized only when the gas was actually delivered in subsequent years.

A. The Trial Court Proceedings.

The United States Tax Court, in a decision reviewed by the full Court, held that the excess payments created production payments within the meaning of Section 636(a) and therefore should be treated as nontaxable loans with income recognized only when the gas was actually delivered.

B. The Court of Appeals Decision.

The Tenth Circuit Court of Appeals reversed the decision of the Tax Court on the basis that OG&E's recoupment rights under the take or pay contract did not give rise to an economic interest in the gas in place sufficient to amount to a production payment for Section 636(a) purposes. This conclusion was reached because the Court determined that OG&E had not made any investment in the gas-producing enterprise and did not look to income derived solely from extraction of the mineral for the return of any investment. The Court concluded that OG&E's interest was an "economic advantage" rather than an "economic interest" in the minerals in place. The Court also discussed the first prong of this Court's test in *Palmer v. Bender*, 287 U.S. 551 (1933), but concluded that its analysis did not lead it to a clear conclusion as to whether OG&E had an interest in minerals in place.

Petitioners' motion for a hearing en banc was overruled. This Petition involves questions concerning the application of the doctrine of economic interest as previously set forth by this Court.

REASONS FOR GRANTING THE WRIT

I.

THE COURT OF APPEALS IMPROPERLY APPLIED THE DOCTRINE OF ECONOMIC INTEREST, AS PREVIOUSLY ESTABLISHED BY DECISIONS OF THIS COURT, TO TAKE OR PAY PAYMENTS

The Tax Court below concluded that the excess payments made by OG&E to the Taxpayers created production payments. The only Tax Court conclusion which was challenged on appeal is whether or not the recoupment rights (the phase "recoupment rights" is the panel's language; Taxpayers would use the phrase "interest in property") constituted an "economic interest." The Tax Court found, and the Commissioner did not challenge, that the other requirements for treating the recoupment rights as production payments are present. Thus, this case revolves around the application of the economic interest doctrine to take or pay payments.

Section 636(a) was added to the Internal Revenue Code of 1954 ("Code") in 1969 to treat production payments as mortgage loans and not as economic interests. One of the requirements for this treatment *not* to be *treated* as an economic interest was that it actually be an economic interest! The change of law was merely the treatment of the production payment, not the test. The test was set forth by this Court long before 1969. Prior to the enactment of the Tax Reform Act of 1969, a production payment was both an economic interest and was so treated for tax purposes. After the Tax Reform Act of 1969, a production payment did not cease being an

economic interest, Section 636(a) merely changed its treatment for tax purposes.

Section 636(a) defines a production payment as follows:

> "A production payment carved out of mineral property shall be treated, for purposes of this subtitle, as if it were a mortgage loan on the property, and shall not qualify as an economic interest in the mineral property."

The regulations, 26 C.F.R. §1.636-3(a)(1) provide in part:

> (a) *Production payment.* (1) The term "production payment" means, in general, a right to a specified share of the production from mineral in place (if, as, and when produced), or the proceeds from such production. Such right must be an economic interest in the mineral in place. It may burden more than one mineral property, and the burdened property need not be an operating mineral interest. Such right must have an expected economic life (at the time of its creation) of shorter duration than the economic life of one or more of the mineral properties burdened thereby. A right to mineral in place which can be required to be satisfied by other than the production of mineral from the burdened mineral property is not an economic interest in mineral in place. A production payment may be limited by a dollar amount, a quantum of mineral, or a period of time. A right to mineral in place has an economic life of shorter duration than the economic life of a mineral property burdened thereby only if such right may not reasonably be expected to extend in substantial amounts over the entire productive life of such mineral property. The term "production payment" includes payments which are commonly referred to as "in-oil payments", "gas payments", or "mineral payments".

> (b) A right which is in substance economically equivalent to a production payment shall be treated as a production payment for purposes of Section 636 and the regulations hereunder, regardless of the language used to describe such right, the method of creation of such right, or the form in which such right is cast (even though such form is that of an operating mineral interest). Whether or not a right is in substance economically equivalent to a production payment shall be determined from all the facts and circumstances. . . .

OG&E's recoupment rights pursuant to its contract with the Taxpayers are the economic equivalent of a production payment and therefore should be so treated in accordance with the Regulations.

The Code Section and regulations cited above derive from the two-prong test first set out by this Court in *Palmer* for determining whether an economic interest is present. That test is: (1) there must be an interest, acquired by capital investment, in the minerals in place and (2) the return of the investment must be realized solely from the extraction of the minerals. See *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308, 314 (1956). Both prongs of the test are satisfied in the take or pay situation.

A.

If Allowed to Stand, This Decision is in Conflict With Prior Decisions of This Court Since It Improperly Applies This Court's Doctrine of "Economic Advantage" to Take or Pay Contracts.

The Court of Appeals' finding that OG&E does not have an interest in the gas-producing enterprise and does not look to income derived solely from extraction of the

mineral for the return of its investment, thereby making OG&E's interest an "economic advantage" rather than an "economic interest," is erroneous.

OG&E clearly has an interest in the well. If the well developed mechanical problems and could no longer produce, OG&E would lose the ability to produce the minerals it paid for earlier; it would lose its interest in the well. This is not the case in any of the cases which have found an economic advantage rather than an economic interest. See *Helvering v. Bankline Oil Co.*, 303 U.S. 362 (1938); *Paragon Jewel Coal Co. v. Commissioner*, 380 U.S. 624 (1965); *Rissler & McMurry Co. v. United States*, 480 F.2d 684 (10th Cir. 1973); and *Utah Salt Co. v. Wise*, 370 F.2d 976 (10th Cir. 1967).

In all of these economic advantage cases, the party incorrectly claiming it had an economic interest lost nothing if the well ceased producing (other than the possibility of making a future profit). These parties' only investment was in the form of equipment to be used for the processing of wet gas, salt, etc. None of the parties had one cent invested in the mineral deposit. Here the total amount of money which OG&E invested was invested in the gas. The very nature of a production payment is that the investment be solely in the mineral. This is an interest in the well.

Commencing with *Bankline*, this Court has required the finding of a capital investment in the mineral deposit by one claiming it possessed an economic interest. OG&E bought the gas from the Taxpayers when it paid the Taxpayers; it parted with its capital at that time. The only thing OG&E received was a right to the mineral deposit.

This payment by OG&E was the required capital investment in the mineral deposit.

The recoupment rights possess all of the characteristics of a production payment. Again, it is only the economic interest issue which is before the Court. The Commissioner has agreed below that the other four characteristics of a production payment are present. An excellent discussion of the characteristics of a production payment can be found in *Standard Oil Company of Texas v. Marshall*, 265 F.2d 46 (5th Cir. 1959):

> " . . . an oil payment is not a conveyance of oil in place, not a promise to pay money, not a contract for sale of oil after production but an incorporeal hereditament in the nature of an overriding royalty creating a present interest in land.
>
> * * *
>
> An oil payment is like an overriding royalty. It is carved out of the lessee's share of the oil, the working interest, as distinguished from the lessor's royalty interest. It differs from an overriding royalty only in that it is of limited duration; it expires when the payor receives a fixed amount from his interest." (265 F.2d at 53, footnote omitted.)

The recoupment rights were carved out of Taxpayer's working interest, and they expire when OG&E receives a fixed amount for their interest. The recoupments rights give OG&E an interest in the mineral.

Under Oklahoma law, an agreement to exchange a production payment for services has been held to be within the statute of frauds indicating that a production payment is an interest in land. *Dille v. Carter Oil Co.*, 192 F.2d 791 (10th Cir. 1951); see also Kuntz, *The Law of Oil and Gas*, Vol. 5, ¶63.3.

The Tenth Circuit stated (at 16-APP) that the excess payments do not entitle OG&E to "anything more than an amount of gas in subsequent years equivalent to that paid for but not taken in earlier years." This is exactly the nature of OG&E's investment. It paid money currently (its investment) to Taxpayers so that it could ensure itself a supply of gas in the future. Since gas cannot be stored, OG&E made a current investment so that its needs can be met in the future.

The Commissioner's *official* position on the proper characterization of the inverest involved in a take or pay situation is directly contrary to what he argued in the Tax Court and to what the Tenth Circuit held. In Revenue Ruling 66-64, 1966-1 C.B. 97, the Commissioner held, in a take or pay situation exactly like the one in this case (title did not pass until production, etc.) that:

> "It is clear that the cost of gas purchased for resale and taken during the contract year in which liability for the payment was incurred gives rise to the acquisition of an asset. Similarly, the fact that the taxpayer defers the taking of all or any portion of the gas until a contract year subsequent to that in which the failure to take the specified quantity of gas contracted for occurred does not alter the nature of that which was acquired by the payment for such gas – *viz*, an asset with an ascertainable fair market value."

Taxpayers could not have stated this any better than the Commissioner. As the Commissioner properly proclaimed in the Revenue Ruling, the payment by OG&E did result in investment in an asset. OG&E acquired an economic interest not a mere economic advantage.

For some reason the Tenth Circuit stated in its opinion (14-APP) that OG&E "certainly does not look to

income derived solely from extraction of the mineral for the return of any investment." As the Tax Court found below, OG&E had nothing else to look to for its return than the income derived from extraction of the gas.

B.

The Court of Appeal's Expansion of the Requirements Necessary for an Economic Interest to Include a Profit in Addition to a Return of Investment is Inconsistent With Prior Decisions of This Court.

Another factor stated by the Court of Appeals for reversal was that OG&E is not seeking through its recoupment right a profit from the extraction of the gas. This is simply not the test set out by the Code or this Court.

As the Tenth Circuit indicated, the test for determining economic interest began with this Court's *Palmer* case. The language cited by the Tenth Circuit is:

> [The depletion statute covers] every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of oil, to which he must look for a *return of his capital*. Id. at 557. (Emphasis added.)

The criteria is the return of his capital. There is simply no requirement under *Palmer* that the holder also make a profit; he merely has to look solely to the extraction of oil for the *return* of his investment. It is not even a requirement that the full investment be returned. The importance of the test is the source of the return not the amount thereof. In the *Rissler* and *Utah Salt* cases, the Tenth

Circuit reaffirmed this Court's rule that the taxpayer must look solely to the extraction of the mineral for the return of its investment. This language, return of investment, has been constantly repeated in decisions of this Court, in the Code and in the Regulations thereunder.

Although this Court's decisions in *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25 (1946), and *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 899 (1946), both have language using the word "profit" in the return of investment context, there is no decision of this Court or any other Court which requires anything more than a return of investment (capital). Both *Burton-Sutton* and *Kirby* dealt with whether a sale had taken place and arose in connection with the granting of an allowance for depletion. There is no such sale or depletion issue present here. The *Palmer* test of return of capital is the appropriate test.

It is certainly true that OG&E intends to make a profit on what it does with the gas after its extraction. This, however, should have no bearing on the issue in this case. OG&E is not in a position to argue that it has an economic interest in the gas after it converts it to electricity so that it could claim depletion on the enhanced value. That is what the taxpayers in *Bankline*, *Rissler*, and *Utah Salt* were claiming. In each situation, those parties were taking a mineral product, enhancing its value and were attempting to claim depletion on the enhanced value of the mineral. Their only investment was in the equipment they used in the production of the mineral and the only return of investment came from profits from their respective enhancement activities.

OG&E paid significant moneys for the gas. It has no investment in equipment with respect to which it needs recoupment. There is no claim that OG&E has an economic interest in the "processed" gas. It merely has an economic interest in the gas it paid for, and therefore it will be entitled to depletion in an amount equal to what it paid for the gas (which should be allowed to it as the recoupment payments are made). Thus, when OG&E's investment has been recouped there will be a concomitant amount of depletion allowed to it. Since OG&E's recoupment rights are an economic interest, the Taxpayers properly treated the excess payments by OG&E as production payments.

C.

The Determination of the Court of Appeals That OG&E's Excess Payments Cannot Properly be Viewed as Investments in the Gas Property is Inconsistent With Prior Decisions of This Court.

In discussing the first prong of the *Palmer* test, the Court of Appeals examined five factors which bear on the issue of whether OG&E has an interest in the minerals in place. The first of these was the degree of legal interest in the minerals. In making this analysis, the Court focused on the legal title to the minerals.

OG&E did not have legal title to the minerals in place at the time it entered into the contract. This Court has previously held that legal title to the minerals in place is not required for the existence of economic interest. *Commissioner v. Southwest Exploration Co.*, supra, and *Kirby Petroleum Co. v. Commissioner*, supra. The take or pay contract provided that title to the gas passed to OG&E

upon production of the gas. In fact, the Tenth Circuit has ruled that OG&E could not have title to the oil or gas in place because:

> " . . . oil and gas in natural state is not susceptible of ownership in place apart from the land in which it is found, but is personal property when reduced to possession. Whether or not title passes upon the occurrence of production must be determined from the language of the lease." *Greenshields v. Warren Petroleum Corp.*, 248 F.2d 61 (10th Cir. 1957), at page 67.

Here OG&E's contract with Taxpayers provides that title passes to OG&E upon production. Even though this Court has found the existence of legal title not to be mandatory, if title is relevant to the consideration, title here did pass to OG&E as soon as it was legally possible to so pass.

The second factor relates to the control over the minerals. The Tax Court found OG&E had control. The Court of Appeals concluded that OG&E possessed at least "significant control".

The third factor was the extent of contribution to the development or operation of the mineral extraction. Prior to 1969, a production payment was used in the so-called ABC transactions to allow the payments of the acquisition price of oil and gas properties with pre-tax instead of after-tax dollars. For this treatment to result, the production payment had to be an economic interest. In all ABC transactions, the purchaser of the production payment never contributed to the production of the gas. It merely bought the production payment. Yet in all cases the production payment was treated as an economic interest.

Taxpayers have found no case in which the economic interest status of a production payment was questioned because it was purchased. On the other hand, the Tenth Circuit has previously held that a purchased production payment is an economic interest. *Commissioner v. I.A. O'Shaughnessy, Inc.*, 124 F.2d 33 (10th Cir. 1941). There is simply no basis for treating the lack of contribution to the development as a factor against OG&E in this context since one who acquires a production payment rarely if ever can meet this test.

The fourth factor, risk of loss, was found to be present by both the Tax Court and the Tenth Circuit.

The fifth and final factor is whether OG&E's recoupment interest in the gas is necessarily reduced as production occurs. When OG&E made its investment in the gas, there was a finite number of feet of gas recoverable from the reservoir. As each foot of gas (whether it is one to which OG&E is entitled or not) is produced, the amount of gas from which OG&E can recoup its investment is reduced. This is what is required by the fifth factor.

Thus a proper analysis of the factors constituting the first prong of the *Palmer* test indicates OG&E meets each of the four factors which can be satisfied by a production payment. Accordingly, this consideration leads to the clear conclusion that OG&E had an interest in the gas in place.

II.

ASSUMING THAT THIS COURT'S PREVIOUS DECISIONS DO NOT FORECLOSE THE DECISION OF THE COURT OF APPEALS, THE COURT OF APPEALS HAS DECIDED AN IMPORTANT QUESTION OF FEDERAL LAW WHICH HAS NOT PREVIOUSLY BEEN DECIDED, WHICH DECISION SHOULD BE MADE BY THIS COURT.

Neither counsel for either party to this action, the Tax Court nor the Tenth Circuit has cited any previously decided case dealing with the federal income tax consequences of payments made pursuant to take or pay contracts. There currently exist estimated claims to amounts due under take or pay contracts in an aggregate amount of several billion dollars, the federal income tax consequences of which are dependent upon the decision in this case.

Perhaps no other area of the federal tax law has more of its genesis in the decisions of this Court than the area of economic interest. It has been many years since this Court has needed to decide a new case in the economic interest area. The taxability of take or pay payments is an issue which is important to the entire oil and gas industry because of the large number of dollars involved and is an issue which should to be decided by this Court.

CONCLUSION

For these reasons, the Petition for Certiorari should be granted.

April 25, 1989

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APPENDIX TO
PETITION FOR WRIT OF CERTIORARI

INDEX TO APPENDIX

Page

Tenth Circuit Court of Appeals Opinion dated November 1, 1988 ..... 1-APP

Order – denying rehearing en banc on January 27, 1989. ..... 16-APP

United States Tax Court Opinion dated March 11, 1986. ..... 18-APP

PUBLISH

UNITED STATES COURT OF APPEALS

FOR THE TENTH CIRCUIT

H.J. FREEDE; JOSEPHINE W. FREEDE; ROGER S. FOLSOM; and MARY M. FOLSOM, Petitioners-Appellees,	)	Nos. 86-2401, 86-2403 (Filed November 1, 1988)
v.	)	
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellant.	)	

ON APPEALS FROM THE DECISIONS OF
THE UNITED STATES TAX COURT
(T.C. Nos. 16339-82, 20768-82)

Bruce R. Ellisen (Roger M. Olsen, Assistant Attorney General; Michael L. Paup; and Ann Belanger Durney, with him on the briefs), Tax Division, Department of Justice, Washington, D.C., for Respondent-Appellant.

Terry R. Hanna of Crowe & Dunlevy (Donald R. Lisle and Charles N. Woodward of Lisle & Woodward, Oklahoma City, Oklahoma, with him on the brief), Oklahoma City, Oklahoma, for Petitioners-Appellees.

Before MOORE, BARRETT, and EBEL, Circuit Judges.

EBEL, Circuit Judge.

H.J. and Josephine Freede and Roger and Mary Folsom ("Taxpayers") petitioned the United States Tax Court for redetermination of alleged deficiencies in taxes for the 1979 tax year.[1] The deficiencies relate to certain excess payments they received from Oklahoma Gas & Electric Company ("OG&E") under a "take or pay" provision in gas supply contracts for gas not taken by OG&E during the year in question. A divided Tax Court held in favor of Taxpayers, finding that the excess payments created "production payments" within the meaning of Section 636(a) of the Internal Revenue Code, 26 U.S.C. § 636(a), and Treas. Reg. § 1.636-3(a), 26 C.F.R. § 1.636-3(a), and therefore should be treated as nontaxable loans with income recognized only when the gas is actually delivered. *Freede v. Commissioner*, 86 T.C. 340 (1986). The Commissioner has appealed, arguing that the excess payments did not create production payments and should be included as income for the year received pursuant to I.R.C. §§ 61(a) & 451(a).[2] We agree with the Commissioner because the excess payments did not give OG&E an economic interest in the gas in place. Accordingly, we reverse.

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[1] Josephine Freede and Mary Folsom are parties solely because they file joint returns with their husbands.

[2] I.R.C. § 61(a), 26 U.S.C. § 61(a), provides that gross income includes "all income from whatever source derived." I.R.C. § 451(a), 26 U.S.C. § 451(a), provides:

> The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

I.

Taxpayers own fractional working interests in various oil and gas leases in Oklahoma. In 1975 and 1976, they entered into "take or pay" gas purchase contracts with OG&E.[3] Under these contracts, OG&E agreed to pay for a specified minimum quantity of gas each year, regardless of whether it took physical delivery of the gas. If the amount of gas paid for under the "take or pay" provision exceeded the amount of gas actually taken from Taxpayers' wells, OG&E had the right to credit the excess amount in later years against gas taken in excess of the minimum contract quantity.[4] However, OG&E would lose the benefit from any excess payments that it did not recoup by taking extra gas within the twenty-year term of the contracts.

In 1979, OG&E made the minimum payment required by the contracts but took less than the minimum contract quantity. Thus, a portion of the contractual payments that

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[3] Although Taxpayers did not appear on the contracts as parties, they were bound by them and performed and received performance as a seller under the terms of the contracts. The contracts are virtually identical and will be referred to collectively.

[4] The contract specifically provides:

> If Buyer shall be required to pay for any gas not taken and received during any contract year, Buyer shall have the right to make up such deficient gas volumes by crediting the volumes of gas so paid for and not taken against such gas as may be taken during any subsequent contract year during the term hereof in excess of the applicable minimum contract quantity for such year. Such gas shall be taken at no additional cost to Buyer.

Taxpayers received from OG&E in 1979 represented payment for gas not actually taken in that year. At that time, the leases had sufficient projected reserves to enable OG&E to recoup the untaken gas in later years if it wanted to do so.

Although Taxpayers were on the cash, as opposed to accrual, method of accounting, they did not include as income the amounts received in 1979 for gas not taken that year. They maintained, and the Tax Court agreed, that OG&E's excess payments created "production payments" pursuant to I.R.C. § 636(a), 26 U.S.C. § 636(a), and therefore the payments should be treated for income tax purposes as if they were loans, with income recognized only when the gas is actually delivered in subsequent years.[5] We disagree.

II.

In order for OG&E's right of recoupment to constitute a production payment under Section 636(a), several criteria must be satisfied: (1) OG&E must have a right to a specified share of gas production or the proceeds from such production; (2) the right must have a specified economic life (at the time of its creation) of less than the economic life of the mineral property which it burdens; (3) the right must be an economic interest in the mineral

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[5] Section 636(a) provides in pertinent part:

> A production payment carved out of mineral property shall be treated, for purposes of this subtitle, as if it were a mortgage loan on the property, and shall not qualify as an economic interest in the mineral property.

in place; (4) the right cannot be satisfied by other than the production of gas from the burdened mineral property; and (5) the right must be limited by either a dollar amount, a quantum of mineral, or a period of time. *See* Treas. Reg. § 1.636-3(a)(1).[6] On appeal, the Commissioner challenges the Tax Court's conclusion with respect to just one of these criteria – that OG&E's recoupment right constituted an "economic interest" in the minerals in place.

A test for determining the existence of an "economic interest" in minerals in place has been derived from

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[6] The regulation, 26 C.F.R. § 1.636-3(a)(1), provides:

> (a) *Production payment.* (1) The term "production payment" means, in general, a right to a specified share of the production from mineral in place (if, as, and when produced), or the proceeds from such production. Such right must be an economic interest in the mineral in place. It may burden more than one mineral property, and the burdened property need not be an operating mineral interest. Such right must have an expected economic life (at the time of its creation) of shorter duration than the economic life of one or more of the mineral properties burdened thereby. A right to mineral in place which can be required to be satisfied by other than the production of mineral from the burdened mineral property is not an economic interest in mineral in place. A production payment may be limited by a dollar amount, a quantum of mineral, or a period of time. A right to mineral in place has an economic life of shorter duration than the economic life of a mineral property burdened thereby only if such right may not reasonably be expected to extend in substantial amounts over the entire productive life of such mineral property. The term "production payment" includes payments which are commonly referred to as "in-oil payments", "gas payments", or "mineral payments."

Palmer v. Bender, 287 U.S. 551 (1933). In that case, the taxpayers had transferred their operating rights in certain oil and gas leases to oil companies in exchange for bonus payments and a right to royalties from the oil produced and saved. They sought to claim depletion on the revenue received. The Tax Commissioner argued that the taxpayers were not entitled to a depletion allowance because the taxpayers had, in effect, sold the leases. In rejecting the Commissioner's argument, the Court held that an economic interest did not depend upon legal title to the mineral. *Id.* at 557. Instead, the Court focused on the taxpayers' investment in the oil in place:

> [The depletion statute covers] every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital.

Id. Under that analysis, the Court found that the taxpayers there had "retained, by their stipulations for royalties, an economic interest in the oil, in place." *Id.* at 558. The Court explained that the taxpayers' investment and their economic risk were directly connected with the production of the oil in place:

> Production and sale of the oil would result in its depletion and also in a return of capital investment to the parties according to their respective interests. The loss or destruction of the oil at any time from the date of the leases until complete extraction would have resulted in loss to the [taxpayers].

Id.

Subsequent courts have characterized *Palmer* as establishing a two-part test for determining whether

there is an economic interest: (1) there must be an interest, acquired by capital investment, in the minerals in place; and (2) the return on the investment must be realized solely from the extraction of the minerals. *See Commissioner v. Southwest Exploration Co.*, 350 U.S. 308, 314 (1956); *Rissler & McMurry Co. v. United States*, 480 F.2d 684, 686 (10th Cir. 1973).[7]

Applying the *Palmer* test to this case, we conclude that OG&E's recoupment rights under the "take or pay" contracts do not give rise to an economic interest in the gas in place sufficient to amount to a production payment for Section 636(a) purposes.[8]

A. *Does OG&E Have an Interest in the Minerals in Place?*

In order for OG&E's recoupment right to satisfy the first prong of the *Palmer* test, OG&E must have an interest in the gas in place. Whether there is an "interest" in minerals in place depends upon an evaluation of various factors, including: (1) the degree of legal interest in the minerals; (2) whether there is significant control over the mineral deposits; (3) the extent of contribution to the

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[7] Most cases analyzing the meaning of "economic interest" have arisen in the depletion context. Nevertheless, the economic interest concept also has been applied to decide whether a transaction is a sale or a lease in capital gains cases, *see United States v. White*, 401 F.2d 610, 613 (10th Cir. 1968) (en banc), and is now one of the requirements for special tax treatment of production payments. *See* Treas. Reg. § 1.636-3(a)(1).

[8] We address only whether a 636(a) production payment was generated by the excess payments made under these "take or pay" provisions, and we do not address other ways in which production payments may be generated.

development or operation of the mineral extraction; (4) risk of loss; and (5) whether the interest is necessarily depleted as the mineral is extracted. *See, e.g., Tidewater Oil Co. v. United States*, 339 F.2d 633, 637 (Ct. Cl. 1964) (discusses legal interest, control, and extent of contribution as factors), *citing* Sneed, *The Economic Interest – An Expanding Concept*, 35 Texas L. Rev. 307, 355 (1957); *Marathon Oil Co. v. Commissioner*, 838 F.2d 1114, 1125 (10th Cir. 1987) (discusses risk as a factor); *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599, 603 (1946) (discusses depletion as a factor). None of these factors is a *sine qua non* for satisfying the first prong of the *Palmer* test. Instead, they all should be considered in reaching an overall determination of whether an interest in the minerals in place has been created. In reviewing the five factors, we find that OG&E's recoupment right satisfies two of them.

As for the first factor, OG&E has no legal title or leasehold interest in the gas or the gas-producing property. In fact, the contracts state specifically that title to the gas passes from seller to buyer at the point of delivery, which occurs at the wellhead or at the outlet of the well separator, if any. Although the absence of title is not determinative, *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599, 603 (1946), it is telling that the Supreme Court has found an economic interest in only one case where a fee or leasehold interest in the mineral property was lacking, *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308 (1956).

In *Southwest*, owners of uplands adjacent to certain offshore oil deposits contracted with a drilling company to allow the company to use their lands for whipstock drilling to reach the oil in return for a share of the

company's profits. The Court held that the upland owners were entitled to a depletion allowance on the amounts received because they had a sufficient "economic interest" in the oil deposits. The Court based this conclusion on the fact that the use of the uplands was essential to the drilling operations because of the proximity of the lands to the deposits and because state law allowed offshore oil deposits to be reached only from drilling on these uplands. Thus, the *third* factor noted above – contribution to the development or operation of the mineral extraction – was prominently met in *Southwest*. The Court was careful to limit its holding to those facts:

> We decide only that where, in the circumstances of this case, a party essential to the drilling for and extraction of oil has made an *indispensable* contribution of the use of real property adjacent to the oil deposits in return for a share in the net profits from the production of oil, that party has an economic interest which entitles him to depletion on the income thus received.

Id. at 317 (emphasis added).

Unlike the upland owners in *Southwest*, OG&E has not met the third factor by contributing to production of the gas or operation of the gas wells. OG&E certainly provided no property or interest that necessarily contributed to production. Instead, its role essentially was one of a customer or buyer of the gas rather than as a producer of the gas. *See* Part II.B below.

With regard to the second factor, we conclude that OG&E does appear to have significant control over the minerals although, as we show later, its control is in the

nature of a buyer's contractual rights rather than as a producer of the gas. The Tax Court based its conclusion that OG&E had an economic interest largely on its finding that OG&E had the contractual power to control production. *Freede*, 86 T.C. at 350. The court noted that OG&E could require the sellers to maintain "deliverability" at 125% of the minimum daily contract quantity and could compel the sellers to deliver gas into the pipeline at the "maximum rate" of production that, in the seller's sole judgment, would not damage the wells or decrease ultimate recovery.[9]

On the other hand, our reading of the contracts reveals that there are a number of important limitations on OG&E's powers over production. First, as Taxpayers concede, the sellers' agreements to maintain deliverability of gas equal to 125% of the daily contract quantity is, under the definitions set forth in the contracts, merely an obligation to maintain deliverability of 100% of what the seller chooses to "ma[k]e available" to the buyer.[10] Thus, this provision by itself does not give

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[9] "Deliverability" is contractually defined as "the volume of gas attributable to Seller's gas reserves actually delivered to Buyer at the point of delivery against the required delivery pressure during the twenty-four hour period following delivery of gas at the maximum rate of flow from Seller's well against the required delivery pressure for a period of three (3) days." The contract also provides that "[e]ither party hereto may request a determination of such deliverability upon giving the other party at least ten (10) days notice prior to the commencement of such test."

[10] This is true because the seller has some control over the minimum contract quantity. The minimum average daily

(Continued on following page)

OG&E control over the amount of production. Rather, the *seller* has control over this amount in the first instance.

Second, although the contract does allow OG&E to compel production at the "maximum rate at which said wells are capable of producing," this is only an "all or nothing" type of control. Moreover, the seller has the right to determine the maximum rate such that production will not damage the wells and will not decrease the ultimate amount of gas which can be recovered from the wells.[11] The contracts also allow the sellers to abandon wells if they determine that the wells are not capable of producing gas in paying quantities. In addition, the seller has the right to sell the gas to others to protect its reservoir against unequal drainage if OG&E is not able to take delivery of sufficient gas to prevent unequal drainage.

Although OG&E certainly does not have unfettered control, we conclude under the contracts before us that OG&E at least possesses "significant" control.

(Continued from previous page)

contract quantity is defined in the contract as the *lesser* of 80% of deliverability against the required delivery pressure *or* 80% of the volume of gas *made available* by the seller to the buyer.

[11] Although the contract leaves this determination to the seller's "sole judgment," it is likely that an implied requirement of reasonableness or good faith would limit the seller's power. *See, e.g., Garr-Woolley v. Martin*, 579 P.2d 206 (Okla. App. 1978) (right under terms of oil and gas lease to remove all fixtures and machinery "at any time" construed as meaning "within a reasonable time"); 12A Okla. Stat. Ann. § 1-203 (good faith requirement under UCC). *See also Big Horn Coal Co. v. Commonwealth Edison Co.*, 852 F.2d 1259, 1267 (10th Cir. 1988).

The third factor concerning contribution to the development of the well is not met here, as discussed above.

The fourth factor – risk of loss – is satisfied here. Risk of loss often has been used as an indicia of an ownership interest. *See, e.g., Marathon Oil Co. v. Commissioner*, 838 F.2d 1114, 1125 (10th Cir. 1987); *Christie v. United States*, 436 F.2d 1216, 1221 (5th Cir. 1971). Here, we conclude that OG&E does bear a risk of losing its recoupment rights if anything were to happen to the property covered by the contracts such that production became inadequate to enable OG&E to recover its recoupment interest over and above the required minimum contract quantities. OG&E has no place to look for recovery of its recoupment interest except to production from the property.

The fifth factor, concerning whether OG&E's recoupment interest in the gas is "necessarily reduced" as production occurs, is not met here. That factor is typically used to determine an "economic interest" in the depletion context. *See Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599, 603 (1946); *Weaver v. Commissioner*, 72 T.C. 594, 600 (1979). OG&E fails to meet this factor because it has been stipulated that reserves exceed OG&E's right to take production, and hence the operator can produce gas from the well without "necessarily" reducing OG&E's recoupment interest. In fact, only if OG&E takes more than the minimum quantity in a given year and elects to use the excess to reduce its right of recoupment will its recoupment interest be diminished by production. Thus, it is possible that up to 20 years of production (the term of the contract) could pass without reducing the recoupment interest.

A consideration of the above factors does not lead us to any clear conclusion as to whether OG&E has an interest in the gas in place under the first prong of the *Palmer* test. A resolution of that issue would require an analysis of the weights to be given to the various factors upon the facts before us. Because we conclude, however, that OG&E's recoupment rights clearly fail the *second* prong of the *Palmer* test, we need not conduct such an analysis.

B. *Does OG&E Look to Income Derived Solely From Extraction of the Mineral for Return of Its Investment?*

OG&E's recoupment right fails to meet the *second* prong of the *Palmer* test because OG&E has not made any investment in the gas-producing enterprise and certainly does not look to income derived solely from extraction of the mineral for the return of any investment. The economic reality is that OG&E's interest is merely that of a consumer paying for gas it receives at the wellhead, not an investor looking for profit from successful extraction. In other words, OG&E's interest is an "economic advantage" rather than an "economic interest" in the minerals in place.

This distinction was first set forth in *Helvering v. Bankline Oil Co.*, 303 U.S. 362 (1938), in which the Supreme Court differentiated between contractual advantages and capital investments:

> [T]he phrase 'economic interest' is not to be taken as embracing a mere economic advantage derived from production, through a contractual relation to the owner, by one who has no capital investment in the mineral deposit.

Id. at 367.[12] In that case the Court held that a processor who had the contractual right to take wet gas from the wellheads and to extract and sell the gasoline therefrom, paying the well owners a share of the proceeds from the sales, had not acquired an economic interest in the gas in place but only an economic advantage. The Court stated that "apart from its contracts with producers, respondent had no interest in the producing wells or in the wet gas in place. Respondent is a processor. It was not engaged in production." *Id.* at 367.

We find that *Bankline* compels reversal here. Like the oil company in *Bankline*, OG&E has contractual rights to take delivery of gas at the wellhead for processing and future sale, but OG&E is not involved in the production of the gas and does not have any legal interest in the wells. Nor are OG&E's excess payments properly viewed as investments in the gas property. They are more like pre-determined damages payable to the producer for gas that was not taken as expected. The fact that those payments are not irretrievably lost but can be recouped by the purchaser out of excess production in later years does not convert them into an investment. Thus, OG&E's recoupment right entitles OG&E to a mere economic advantage and does not constitute an economic interest in the minerals in place. *See also Parsons v. Smith*, 359 U.S.

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[12] Treas. Reg. § 1.611-1(b)(1) contains a similar distinction between an economic interest and an economic advantage. It provides that "[a] person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production."

215, 224-26 (1958); *Rissler & McMurry Co. v. United States*, 480 F.2d 684, 687 (10th Cir. 1973).

Furthermore, OG&E is not seeking, through its recoupment right, a profit from the *extraction* of gas. One indication of an economic interest is the "possibility of profit" that is "dependent solely on the extraction and sale" of the mineral. *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25, 34-35 (1946); *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599, 604 (1946).[13] OG&E, however, is not an investor seeking profit from gas production. Its excess payments do not entitle it to anything more than an amount of gas in subsequent years equivalent to that paid for but not taken in earlier years. If OG&E recovers its recoupment gas in later years it will merely be taking late delivery of gas that it paid for earlier at the price agreed to by the parties. If it does not recover recoupment gas before the expiration of its contract, it will suffer a loss, not a profit. The "take or pay" obligation merely made OG&E a more attractive customer to the Taxpayers, not an investor in the property. OG&E's profit is derived solely from the remarketing of the gas to its customers downstream from production, and not from production itself.[14]

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[13] *See also S.E.C. v. Howey Co.*, 328 U.S. 293, 298-99 (1946) (defining "investment contract" in the securities context as a "contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party").

[14] Additional evidence of OG&E's consumer status are contractual provisions which give it the ability to reject and refuse to pay for gas that does not meet quality specifications.

We conclude that OG&E's recoupment rights do not amount to an "economic interest" in the minerals in place because they do not satisfy the second prong of the *Palmer* test. Therefore, we hold that OG&E's excess payments did not create production payments for Section 636(a) purposes and thus should be included in Taxpayers' income in the year received.

REVERSED.

January 27, 1989

Before Honorable James E. Barrett, Honorable Monroe G. McKay, Honorable James K. Logan, Honorable Stephanie K. Seymour, Honorable John P. Moore, Honorable Stephen H. Anderson, Honorable Deanell R. Tacha, Honorable Bobby R. Baldock, Honorable Wade Brorby and Honorable David M. Ebel, Circuit Judges

H.J. FREEDE; JOSEPHINE W. FREEDE; ROGER S. FOLSOM; and MARY M. FOLSOM, Petitioners-Appellees,	)	Nos. 86-2401, 86-2403
vs.	)	
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellant.	)	

The court's opinion was filed in the captioned cases on November 1, 1988. The panel judges, upon their own motion, hereby revise that opinion by amending the second sentence of the last paragraph on page 14 to read:

> One indication of an economic interest is the "possibility of profit" that is "dependent solely on the extraction and sale" of the mineral.

The court also has for consideration appellee's petition for rehearing and suggestion for rehearing en banc.

Upon consideration whereof, the petition for rehearing is denied by the panel that rendered the decision sought to be reheard.

In accordance with Rule 35(b) of the Federal Rules of Appellate Procedure, the petition for rehearing and suggestion for rehearing en banc were transmitted to all the judges of the court in regular active service. No member of the hearing panel and no judge in regular active service on the court having requested that the court be polled on hearing en banc, Rule 35, Federal Rules of Appellate Procedure, the suggestion for rehearing en banc is denied.

Judge Holloway did not participate in consideration or disposition of the suggestion for rehearing en banc.

ROBERT L. HOECKER, Clerk

86 T. C. No. 22

UNITED STATES TAX COURT

H. J. FREEDE and JOSEPHINE W. FREEDE, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

ROGER S. FOLSOM and MARY M. FOLSOM, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 16339-82, 20768-82. Filed March 11, 1986.

Petitioners, as owners of fractions of the working interests in an oil and gas lease, were subject to contracts for the sale of natural gas to OG & E for 20 years. The contracts obligated OG & E to take or pay for a minimum of 80 percent of the deliverable gas from the leases. If the amounts paid exceeded the value of the gas actually delivered, OG & E was entitled to gas actually produced in the later years equal to the excess without additional payment. In 1979, the payments by OG & E exceeded the value of gas actually delivered. The projected reserves were adequate to supply OG & E with gas which was paid for but not received in 1979.

Held, the payments for gas not taken by OG & E create a production payment within the meaning of sec. 636(a), I.R.C. 1954, and sec. 1.636-3(a), Income Tax Regs. The payments, therefore, from OG & E to petitioners in 1979 are characterized under sec. 636(a), I.R.C. 1954, as nontaxable loans.

Terry R. Hanna, for the petitioners in docket No. 16339-82.

Donald R. Lisle, for the petitioners in docket No. 20768-82.

Osmun R. Latrobe, for the respondent.

OPINION

GOFFE, *Judge:* The Commissioner determined the following deficiencies in petitioners' Federal income taxes for the taxable years 1978 and 1979:

Petitioner	*Taxable Year*	*Deficiency*
H.J. and Josephine W. Freede	1978	$105,758.53
	1979	551,348.33
Roger S. and Mary M. Folsom	1978	8,056.00
	1979	97,444.00

The two cases, docket Nos. 16339-82 and 20768-82, were consolidated for trial, briefing, and opinion. The parties have settled numerous adjustments determined by the Commissioner in the statutory notices of deficiency. The sole issue for decision is whether petitioners are required to include in taxable income for the taxable year 1979 amounts received from Oklahoma Gas and Electric (hereinafter referred to as OG & E) pursuant to a "take or pay" Gas Purchase Contract.

All of the facts have been stipulated and the consolidated case was submitted to this Court without trial pursuant to Rule 122.[1] The stipulations of facts and accompanying exhibits are so found and incorporated by reference.

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[1] All rule references are to this Court's Rules of Practice and Procedure. All statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years in issue.

At the time of filing the petitions in this case, H. J. and Josephine W. Freede, husband and wife, and Roger S. and Mary M. Folsom, husband and wife, resided in Oklahoma City, Oklahoma. Petitioners H. J. and Josephine W. Freede filed timely joint Federal income tax returns for the taxable years 1978 and 1979 with the Internal Revenue Service Center in Austin, Texas. Petitioners Roger S. and Mary M. Folsom filed timely joint Federal tax returns for the taxable years 1978 and 1979 with the Internal Revenue Service Center in Austin, Texas. Josephine W. Freede and Mary M. Folsom are parties in this case solely because they filed joint returns with their husbands. H. J. Freede (Freede) and Roger S. Folsom (Folsom) will be referred to jointly as petitioners.

During the taxable years at issue, petitioners were each, in addition to their other income producing activities, in the business of producing oil and gas. They carried out their business by purchasing fractional working interests in various mineral leases, which were then developed and operated by others. They each had adopted and used the cash receipts and disbursements method of accounting.

During the taxable years at issue, Freede and Folsom held working interests in Endicott No. 1 lease in Blaine County, Oklahoma, of .04362 percent and .013672 percent, respectively. The production from the lease consisted principally of natural gas.

On or about October 28, 1975, a Gas Purchase Contract for the production of natural gas from the Endicott No. 1 lease was entered into between OG & E as purchaser and An-Son Corporation as seller. On or about

January 14, 1976, a Gas Purchase Contract for the production of natural gas from the Endicott No. 1 lease was entered into between OG & E as purchaser and A. Ben Chadwell and Julie Racz as seller. Although neither Folsom nor Freede appeared on either contract as parties, both petitioners were bound by, performed, and received performance as sellers under the terms of the contracts. The terms of both contracts are virtually identical, with the exception of slight differences such as the local base prices. All references to the contracts, purchaser, or seller for the remainder of this opinion refer to both contracts and the parties to both contracts, collectively.

The primary terms of the contracts were for 20 years. All of the gas produced and saved from the lease, with minor reservations, was sold to the purchaser.[2] The contracts required that the seller make 100 percent of the deliverability[3] of each well covered by the lease available to the purchaser. The contracts also included a "take or pay" provision which required the purchaser to pay for

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[2] The price paid was set with reference to a local base price, escalating one cent per thousand cubic feet each year thereafter, subject to adjustments upwards or cancellation of the contract under certain circumstances.

[3] "Deliverability" is defined in the contracts as the volume of gas attributable to Seller's gas reserves actually delivered to Buyer at the point of delivery against the required delivery pressure during the 24-hour period following delivery of gas at the maximum rate of flow from Seller's wells against the required delivery pressure for a period of 3 days. For convenience that term will be used in this opinion although, in general terms, it could describe "production" from the wells.

80 percent of the deliverability of each well covered by the lease, regardless of whether the purchaser took physical delivery of any gas at all.[4] The amount of gas or substituted payment under the "take or pay" obligation was also referred to as the minimum contract quantity. The seller was obligated to maintain deliverability of 125 percent of the minimum contract quantity.

Under the contracts, if the amounts paid in any taxable year exceeded the amounts attributable to the gas actually taken, OG & E was entitled to an offset for the excess payments in subsequent years to the extent that the gas taken in later years exceeded the minimum contract quantity. Thus the purchaser was not obligated to pay for the gas taken in future years until the value of the gas taken exceeded both the minimum contract quantity payments for that year and the excess payments made in earlier years. So long as the purchaser continued to make minimum payments, the contracts did not require that the purchaser take even a minimum of gas in any particular year. If the payments exceeded the value of the gas taken, however, the purchaser's only right of recoupment was from the production of gas in excess of the minimum contract quantities in future years. The purchaser's right of recoupment or recovery was protected, however, by the fact that OG & E could require that the seller produce

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[4] The "take or pay" obligation was reduced in the event that the seller was unable to maintain normal deliverability. In that case, the purchaser was required only to take or pay for 80 percent of the production actually made available to the purchaser.

gas in an amount equal to 100 percent of the deliverability of each well covered by the lease, or 25 percent in excess of the minimum contractual amounts.

Pursuant to the contracts, the purchaser made the minimum payments to the seller in the taxable year 1979 calculated with reference to 80 percent of the deliverability of each well covered by the lease, as set forth by the contracts. A portion of the payment was for gas actually taken under the contracts. As the amount of gas taken was not equal to or more than the minimum contract quantity, a portion of the minimum contract amount paid under the terms of the contracts was for the difference between the gas taken and the minimum contract quantity of gas. Under the terms of the contracts, OG & E was, therefore, not obligated to pay for gas taken in subsequent years in excess of the minimum contract rate until the amounts paid in 1979 were offset by the additional gas taken. In 1979, the lease had sufficient projected reserves to repay OG & E in gas, prior to the expiration of the contracts, for the contractual minimum payments paid for gas not taken.

As owners of portions of the working interest, Freede and Folsom received payments from OG & E in the taxable year 1979 in the respective amounts of $462,881.30 and $205,963.44. The amounts received represented both payments for gas actually taken by OG & E and payments for the difference between the amount OG & E was contractually obligated to pay for and the volume of gas actually taken. The respective amounts are as follows:

Type of Payment	*Freede*	*Folsom*
Payments for gas taken	$119,626.14	$ 64,802.26
Payment for the difference between minimum contractual payment and payment made for gas taken	343,255.16	141,161.18
Total payments to petitioners	$462,881.30	$205,963.44

The amounts representing payments for gas actually taken by OG & E were included as income by petitioners on their respective Federal income tax returns for the taxable year 1979. The payments made pursuant to the contractual minimum that represented advance payments for gas not taken were not included by either petitioner as income for the taxable year 1979. Both petitioners decided to include in income for later taxable years payments for gas taken by OG & E during those years in excess of the minimum contract quantity.

Petitioners contend that the advance payments received under the "take or pay" contracts with OG & E create an economic interest entitling OG & E to production payments under section 636(a). If the advance payments are an investment in future production, the minimum contract payments paid for gas not taken in 1979 would be treated as loans from OG & E to petitioners, with income recognized only when the gas is actually delivered in subsequent years. Respondent contends that the entire amounts received from OG & E constitute realized income which should be recognized

under section 61(a) and section 451,[5] citing Rev. Rul. 80-48, 1980-1 C.B. 99.

A production payment, in general terms, is a right to minerals in place that entitles its owner to a specified share of production for a limited time from a specified mineral property when production occurs. Sec. 1.636-3(a)(1), Income Tax Regs.; see H. Rept. 91-413 (1969), 1969-3 C.B. 200; S. Rept. 91-552 (1969), 1969-3 C.B. 423; F. Burke & R. Bowhay, Income Taxation of Natural Resources, par. 2.07, at 206 (1985). A "carved-out" production payment arises where the owner of an interest in a mineral property assigns a production payment to another person but retains his interest in the property from which the production payment is assigned. If such a production payment is created, section 636(a) describes the tax consequences:

> (a) Carved-out Production Payment. – A production payment carved out of mineral property shall be treated, for purposes of this subtitle, as if it were a mortgage loan on the property, and shall not qualify as an economic interest in the mineral property. * * *

It is important to the discussion which follows to point out that although section 636(a) and the regulations

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[5] Sec. 61(a) provides that gross income includes all income from whatever source derived. Sec. 451 provides that:

> The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

thereunder require that the production payment be an actual economic interest, the transaction nevertheless is treated as a loan for Federal income tax purposes.

Sections 1.636-3(a)(1) and (2), Income Tax Regs., further define the term "production payment":

> (a) *Production payment.* (1) The term "production payment" means, in general, a right to a specified share of the production from mineral in place (if, as, and when produced), or the proceeds from such production. Such right must be an economic interest in such mineral in place. It may burden more than one mineral property, and the burdened mineral property need not be an operating mineral interest. Such right must have an expected economic life (at the time of its creation) of shorter duration than the economic life of one or more of the mineral properties burdened thereby. A right to mineral in place which can be required to be satisfied by other than the production of mineral from the burdened mineral property is not an economic interest in mineral in place. A production payment may be limited by a dollar amount, a quantum of mineral, or a period of time. A right to mineral in place has an economic life of shorter duration than the economic life of a mineral property burdened thereby only if such right may not reasonably be expected to extend in substantial amounts over the entire productive life of such mineral property. The term "production payment" includes payments which are commonly referred to as "in-oil payments", "gas payments", or "mineral payments".
>
> (2) A right which is in substance economically equivalent to a production payment shall be treated as a production payment for purposes of section 636 and the regulations thereunder, regardless of the language used to describe such right, the method of creation of such right, or the form in which such right is cast (even though such form is that of an

> operating mineral interest). Whether or not a right is in substance economically equivalent to a production payment shall be determined from all the facts and circumstances. * * *

Section 1.636-1(a)(1)(ii), Income Tax Regs., prescribes the tax consequences as follows:

> The payer of a production payment treated as a loan pursuant to this section shall include the proceeds from (or, if paid in kind, the value of) the mineral produced and applied to the satisfaction of the production payment in his gross income and "gross income from the property" (see section 613(a)) for the taxable year so applied. The payee shall include in his gross income (but not "gross income from property") amounts received with respect to such production payment to the extent that such amounts would be includible in gross income if such production payment were a loan. The payer and payee shall determine their allowable deduction as if such production payment were a loan. * * *

The treatment of the advance payments and the resultant tax consequences depend upon whether or not such payments are an investment in future production that create a production payment constituting an economic interest under sections 611 and 636. Applying the Code and regulations to this case, the question is whether the advance payments from OG & E to petitioners which create a right in OG & E to share in the future production of gas are, under section 636(a), treated as production payments. If so, then the payments to petitioners by OG & E would be characterized under section 636(a) as loans from OG & E to petitioners which would not be taxable income to petitioners in the year before the Court.

The criteria that must be satisfied under the terms of the statutes and regulations set forth above are: (1) the purchaser must have a right to a specified share of production or the proceeds from such production; (2) the interest must have an expected economic life (at the time of its creation) of shorter duration than the economic life of the mineral property upon which it is a burden; (3) the right must be an economic interest in the mineral in place; (4) the interest must not be able to be satisfied by other than the production of mineral from the burdened mineral property; and (5) the production payment must be limited by either a dollar amount, a quantum of mineral, or a period of time. In this case, each of the criteria has been met.

The contracts provide that the purchaser is entitled to the entire production of the lease, and is required to take or pay for 80 percent of the deliverability of each well covered by the lease. The sellers agreed to maintain deliverability and production of each well at 100 percent, which is 125 percent of the minimum contract quantity. OG & E clearly has the right to a specified share of the production from the lease, thus satisfying the first criterion.

The second criterion has also been met in that OG & E can recoup the amounts paid for gas not received from the projected reserves prior to the termination of the contracts. The economic life of the interest created by the advance payments is thus limited to the terms of the contracts, which are shorter than the economic life of the property.

The third criterion, however, is the principal point upon which the parties disagree. In order for the advance payments to be treated as an investment in future production by OG & E rather than as income to petitioners, payments made pursuant to the contracts must create a depletable economic interest as defined in section 1.611-1(b)(1), Income Tax Regs.:

> An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for the return of his capital. For an exception in the case of certain mineral production payments, see section 636 and the regulations thereunder. A person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction or cutting does not convey a depletable economic interest. * * *

Petitioners contend that OG & E acquired an economic interest in the gas in place by virtue of the rights and obligations under the "take or pay" contracts. Respondent argues the converse, proposing that OG & E had merely a contractual right to receive the gas, not a property interest in the gas itself; OG & E had at best an "economic advantage," not an "economic interest."

Although section 1.611-1(b), Income Tax Regs., purports to adequately define the term "economic interest," a

number of cases have expanded upon the vague meaning of the term. Even the courts, however, have found it difficult to single out one recurring factor that clearly indicates ownership of an economic interest in the minerals in place. *Tidewater Oil Co. v. United States*, 168 Ct. Cl. 457, 339 F.2d 633 (1964).

The purchaser need not have legal title to the property to have an economic interest,

> [i]t is enough if, by virtue of the leasing transaction, he has retained a right to share in the oil produced. If so he has an economic interest in the oil, in place, which is depleted by production. * * * [*Palmer v. Bender*, 287 U.S. 551, 557 (1933).]

A taxpayer has an "economic interest" in minerals regardless of the legal form of the interest if he has acquired the interest by investment in the minerals in place, and looks to the extraction of the minerals for the return of his investment. *Gulf Oil Corp. v. Commissioner*, 86 T.C. ___ (Jan. 30, 1986); *Husky Oil Co. v. Commissioner*, 83 T.C. 717, 739-741 (1984), on appeal (10th Cir. Oct. 24, 1985); *Thomas v. Perkins*, 301 U.S. 655, 661 (1937).

For an interest to be an economic interest within the terms of section 636(a), the payments must be in exchange for the receipt of minerals and there must also be an investment in the production of the minerals. *Gibson Products Co. v. United States*, 637 F.2d 1041 (5th Cir. 1981); *Weaver v. Commissioner*, 72 T.C. 594 (1979). Thus, where the taxpayer was merely a processor of oil and was not engaged in production, the taxpayer had no interest in the mineral in place. The fact that the taxpayer obtained an economic advantage from the production of the gas was not adequate basis for the creation of an

economic interest. *Helvering v. Bankline Oil Co.*, 303 U.S. 362, 367-369 (1938). "The test * * * is whether the taxpayer has a capital investment in the oil in place which is necessarily reduced as the oil is extracted." *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599, 603 (1946). "Economic interest does not mean title to the oil in place but the possibility of profit from that economic interest dependent solely upon the extraction and sale of the oil." *Kirby Petroleum Co. v. Commissioner, supra* at 604; *Gulf Oil Corp. v. Commissioner, supra.*

Although the cases cited above repeatedly conclude that title is not required as a prerequisite to an economic interest, no taxpayer was found to possess an "economic interest" who did not also hold either a fee interest or a leasehold interest in the mineral property until *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308 (1956). The taxpayers were fee owners of upland adjoining property that the State of California required that the operator use for access, by means of slant drilling, to the offshore mineral properties. The taxpayers granted the operator the right to drill in exchange for a net profits interest, and subsequently claimed depletion on the amounts received. The Supreme Court held that the taxpayers, although neither owners of the fee interest nor lessors of the minerals had an "economic interest" upon which they were entitled to depletion. In so holding, the Court held:

> It is true that the exclusive right to drill was granted to Southwest, and it is also true that the agreements expressly create no interest in the oil in the upland owners. But the tax law deals in economic realities, not legal abstractions, and upon closer analysis it becomes clear that these factors do not preclude an economic interest in the upland owners. [350 U.S. at 315.]

Respondent contends that the facts of this case are indistinguishable from *Helvering v. Bankline Oil Co., supra.* In that case, the taxpayer was merely a processor of the mineral and possessed no other rights whatsoever with respect to the mineral in place. The Supreme Court found that Bankline was afforded only "economic advantage" by virtue of the contract, rather than an economic interest in the minerals in place. 303 U.S. at 367. Respondent argues that OG & E also has no more than an economic advantage derived from the mere processing of the minerals made available to it under the contracts. Respondent's conclusion is that OG & E cannot, therefore, satisfy the third requirement for a production payment under section 636 because an economic advantage is not equivalent to an economic interest.

Petitioners argue that OG & E's interest in the production of gas from the lease rises to the level of an economic interest, due to the contractual rights and obligations of OG & E. We agree with petitioners.

Under the contracts, OG & E has the obligation to take or pay for 80 percent of the deliverability of each well covered by the lease. OG & E, however, also has the right to require the producers to maintain production equal to 100 percent of the deliverability of each well, or an amount equal to 125 percent of the minimum contract quantity. If OG & E pays an amount in excess of the value of gas actually taken, it has the right to offset the payments against any amounts produced in subsequent years in excess of the applicable minimum contract quantity. OG & E, in essence, has both rights to the minerals in place and a means of controlling production. Although OG & E did not have legal title to the minerals, title is not

the controlling factor. *Kirby Petroleum Co. v. Commissioner, supra* at 604. When the rights and obligations of OG & E under the contracts are viewed in their entirety, they rise to the equivalent of an economic interest under the statute, regulations, and case law.

The fourth factor that must be satisfied under section 1.636-3(a)(1), Income Tax Regs., for the advance payments to be treated as creating a production payment is that the advance payments must be satisfied only from the production of mineral from the burdened property. Under the contracts, OG & E pays an amount each year equal to 80 percent of the deliverability of each well covered by the lease, whether or not it takes the minimum contract quantity of gas. The only method by which OG & E can obtain value for the payments made is to take an additional amount of gas over the minimum contract quantity in future years. Further, the sellers are required to produce the gas which will repay OG & E for the amounts previously paid. OG & E has no other source for repayment other than the future production of gas from the lease specified in the contracts. The fourth criterion has been satisfied.

The final criterion is that the production payment must be a specified share of production limited by either a dollar amount, a quantum of mineral, or a period of time. In this case, the contracts provide that the advance payments are the equivalent of advance payment for gas to be received later. In each year OG & E must take or pay for 80 percent of the deliverability of the wells. In years when OG & E takes gas that it has previously paid for, that deliverability must come from the remaining 20 percent of production. Only the excess production above that

amount can be used for recoupment of the advance payments. OG & E can, however, compel production of that final 20 percent of production, otherwise defined as 125 percent of the minimum contract quantity. The amount of gas delivered is limited by the maximum amount of deliverability that can be imposed by OG & E, and is further limited by the fact that the contracts have a 20-year term within which OG & E must, if at all, recoup the advance payments from production. The fifth criterion is also satisfied under the facts of this case, and the requirements for a production payment as set forth in the statute and regulations thereunder have been met.

Respondent's final argument, however, is that Rev. Rul. 80-48, 1980-1 C.B. 99, sets forth the proper approach toward "take or pay" gas contracts and that such contracts create no more than an economic advantage. Rev. Rul. 80-48, *supra*, describes a "take or pay" gas purchase contract similar to the factual situation here: Y purchases a specified amount of gas from the taxpayer each month, but pays whether or not Y chooses to take the entire monthly production. Any advance payments made by Y create a right to future excess production without additional payment. The authors of the ruling conclude that:

> An agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production does not convey a depletable economic interest in mineral in place.
>
> The taxpayer, in this case, entered into an agreement with Y under the terms of which Y must purchase each month, for the life of the contract, a specified amount of gas. However, Y need not take the gas. Under the provisions of section 1.611-1(b) of the regulations such an agreement does not convey a

> depletable economic interest in mineral in place. [1980-1 C.B. at 99-100.]

A revenue ruling is no more than a statement of the Commissioner's position, and is "not entitled to any particular weight." *Anselmo v. Commissioner*, 80 T.C. 872, 883 n. 13 (1983), affd. 757 F.2d 1208 (11th Cir. 1985). The Fifth Circuit has further described the value of a revenue ruling:

> A ruling is merely the opinion of a lawyer in the agency and must be accepted as such. It may be helpful in interpreting a statute, but it is not binding on the Secretary or the courts. It does not have the effect of a regulation or a Treasury Decision. [*Stubbs, Overbeck & Associates, Inc. v. United States*, 445 F.2d 1142, 1146-1147 (5th Cir. 1971).]

The support offered for the conclusion drawn in the revenue ruling is section 1.611-1(b), Income Tax Regs., which provides that an agreement for purchase upon production is not a conveyance of a depletable economic interest in mineral in place.[6] As pointed out above, however, the "take or pay" contracts at issue in this case are

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[6] This revenue ruling has been discussed and in some cases criticized in oil and gas taxation texts and periodicals. See 2 L. Fiske, Federal Taxation of Oil & Gas Transactions, sec. 8.12 (1983); 1 Energy Resources Tax Reports (CCH) pars. 651-653 (1983); F. Burke & R. Bowhay, Income Taxation of Natural Resources, par. 15.15, at 1518 (1985); A. Bruen & W. Taylor, Federal Income Taxation of Oil & Gas Investments, par. 8.07[6][a] (1983 and Supp. 1985); Emery, "Current Developments in Oil and Gas Taxation," 32d Ann. Inst. on Oil & Gas L. Taxation 335, 352-353 (1981); Haschke, Crump & Huggins, "Mineral Production Payments; Gas 'Take or Pay' Purchase

(Continued on following page)

not merely agreements to purchase if production occurs. OG & E has a right of recoupment for the advance payments limited solely to future production of minerals and may compel production to satisfy the recoupment rights created by the advance payments. In essence, the purchaser has acquired by investment (the advance payments) an interest in the gas in place, which may be satisfied solely from the minerals extracted, thus fulfilling the definition of an economic interest under section 1.611-1(b)(i), Income Tax Regs.

We hold that a production payment as defined by section 1.636-3(a), Income Tax Regs., has been created, and the payments received in 1979 in excess of payments for gas delivered, are not taxable in 1979.

Decisions will be entered under Rule 155.

Reviewed by the Court.

STERRETT, SIMPSON, CHABOT, PARKER, WHITAKER, HAMBLEN, COHEN, CLAPP, SWIFT, and WRIGHT, *JJ.*, agree with the majority opinion.

WILBUR, KORNER, SHIELDS, and GERBER, *JJ.*, did not participate in the consideration of this case.

(Continued from previous page)

Contract," 28 Oil & Gas Tax Quarterly 564 (1981); Burke & Karpen, "New Revenue Ruling 80-48: A Blueprint for Recreating Carved-out Production Payments?" 53 J. Taxation 370 (1980).

NIMS, *J.*, dissenting: I respectfully dissent, since I cannot agree that OG & E obtained a depletable economic interest in minerals in place as required by the regulations. Section 1.636-1(a)(1)(i); section 1.611-1(b), Income Tax Regs. Unless this paramount condition is met there is no production payment to which section 636(a) can apply.

A paradigm form of production payment is illustrated by the facts in *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958). The Supreme Court summarized the facts as follows:

> Lake is a corporation engaged in the business of producing oil and gas. It has a seven-eighths working interest in two commercial oil and gas leases. In 1950 it was indebted to its president in the sum of $600,000 and in consideration of his cancellation of the debt assigned him an oil payment right in the amount of $600,000, plus an amount equal to interest at 3 percent a year on the unpaid balance remaining from month to month, payable out of 25 percent of the oil attributable to the taxpayer's working interest in the two leases. At the time of the assignment it could have been estimated with reasonable accuracy that the assigned oil payment right would pay out in three or more years. It did in fact pay out in a little over three years. [356 U.S. at 261-262].

The legislative history of section 636(a) (enacted in 1969) makes it clear that the section was a legislative response to certain perceived tax avoidance schemes following in the wake of *P.G. Lake*. See S. Rept. 91-552, 1969-3 C.B. 423, 538. For example, by certain maneuvering with production payments taxpayers were said to be able to avoid the 50 percent taxable income limitation for percentage depletion purposes, the foreign tax credit limitation, the 5-year net operating loss carryover limitation

and the seven-year investment credit limitation. Taxpayers were also seen as being able to amortize or pay off what was essentially a loan with before-tax dollars. 1969-3 C.B. at 539.

The Congressional response, as reflected in section 636(a), was to provide that production payment transactions in general are to be treated as loan transactions. I do not believe, however, that by taking this step to close one loophole Congress intended to open another. I agree that the form of a production payment transaction and that of a mortgage loan need not be precise analogues as the regulations themselves make clear.[1] Nevertheless, taxpayers must always make a threshold showing that the rights conveyed were a production payment; i.e., a depletable economic interest in minerals in place. I think petitioners have failed in their attempt to do so in this case.

As the regulations make clear, "an economic interest is possessed in every case in which the taxpayer [e.g., OG & E] has *acquired by investment* any interest in *mineral in place* * * * and secures, by any form of legal relationship, income derived from the extraction of the mineral * * *, to which he [OG & E] must look for a return of his capital." (Emphasis added.) Section 1.611-1(b)(1), Income Tax

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[1] Section 1.636-3(a)(2), Income Tax Regs., provides that "[a] right which is in substance economically equivalent to a production payment shall be treated as a production payment for purposes of section 636 and the regulations thereunder, regardless of the language used to describe such right, the method of creation of such right, or the form in which such right is cast (even though such form is that of an operating mineral interest.)"

Regs.[2] By this definition, OG & E must have acquired the gas as an investment and be recovering its capital through sales to third parties. That is not, in fact what happened. It seems plain to me that OG & E is simply buying petitioners' gas at the wellhead, not mineral in place. OG & E then presumably transports the gas through its pipeline to its processing plant, for later sale to consumers.

I think this case is controlled by the Supreme Court's decision in *Helvering v. Bankline Oil Co.*, 303 U.S. 362 (1938). One of the contracts involved in *Bankline* provided for the purchase by the taxpayer from the producer of "all natural gas produced at a given well, the [taxpayer] paying 33-1/3 percent of the gross proceeds received by it from the sale of the gasoline extracted from such gas." The Supreme Court quoted with approval the government's representation that "under the contracts [taxpayer] took no part in the production of the * * * gas, conducted no drilling operations upon any of the producing premises, did not pump oil or gas from the wells, and had no interest as a lessor or lessee, or as sublessor or sublessee, in any of the producing wells." 303 U.S. at 365. The purchaser [taxpayer] merely attached pipelines to the various wells and carried the gas from those wells to its processing plant where the gas was commingled with gas from other sources.

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[2] Section 1.611-1(b)(1), Income Tax Regs., has been characterized as having been drawn primarily from the opinions in *Palmer v. Bender*, 287 U.S. 551 (1933) and *Helvering v. Bankline Oil Co.*, 303 U.S. 362 (1938). See 1 B. Bittker, Federal Income Taxation of Income, Estates and Gifts, par. 24.1.2, p. 24-7 (1981 ed.).

The Supreme Court pointed out in *Bankline* that "[s]ome of the contracts, reciting that the producer was the owner of the gas produced, provided for its treatment [i.e., reduction of dry gas to gasoline] by [taxpayer]. Other contracts were couched in terms of purchase. In either case the gas was to be delivered to [taxpayer] at the casingheads or gas traps installed by the producer." 303 U.S. at 367-368.

The Court went on to say that "[t]he controlling fact is that [purchaser] had no interest in the gas in place. [Purchaser] had no capital investment in the mineral deposit which suffered depletion and is not entitled to the statutory allowance." 303 U.S. at 368.

I believe that OG & E is in exactly the same posture here as was the purchaser-taxpayer in *Bankline Oil Co.* The contracts in this case speak in terms of gas "sold and delivered" to OG & E. Section 2.2 provides that "[s]eller [petitioners] shall have the right to operate wells from which gas is produced * * * for delivery "into Buyer's pipeline [i.e., OG & E's pipeline.]" Article 5, entitled "Points of Delivery and Delivery Pressure," provides that the gas produced "shall be delivered at the wellhead of each well, or at the outlet of the well separator, if any. *Title to all gas sold hereunder shall pass from Seller to Buyer at said point of delivery.*" (Emphasis added.) There is absolutely nothing in either contract which says anything about OG & E making a capital investment in the gas in place. It follows, then, that this case simply does not involve production payments, and section 636(a) does not apply.

Section 61(a) provides that "gross income means all income from whatever source derived." Section 451 provides that "[t]he amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period." Under the facts of this case, the $484,416.34 received by petitioners in the years before the Court, and which the majority permits petitioners to defer for up to 20 years, should be included in petitioners' gross income in the years received, and I would so hold.

JACOBS, PARR, and WILLIAMS, *JJ.*, agree with this dissent.

PARR, *J.*, dissenting: In addition to the reasons articulated in the dissenting opinions of Judges Nims and Williams, in which I have joined, I dissent on an additional ground. What the majority has done here in holding that OG & E possesses an economic interest in the mineral in place extends the concept of "economic interest" much too broadly, and may provoke unforeseen consequences. This concept is fundamental in determining the tax consequences of transactions involving mineral properties. In particular, it is critical in determining who receives gross income from the property, who is entitled to depletion, and whether the disposition of an interest is a sale or a lease.

The majority's opinion has the result of elevating a prepaid contractual right to a supply of a mineral to the

level of an investment in the mineral in place, an economic interest. In this case, the majority's finding of an economic interest leads to the finding that a production payment exists, which is treated not as a depletable economic interest but as a loan, pursuant to section 636. It might be argued in this context that there has been no shifting of ordinary depletable income and thus little or no abuse in terms of tax dollars as a result of this decision, if both parties reported the transaction consistently.[1] However, in other contexts the finding that such a contractual right amounts to an economic interest may have a greater tax impact, such as entitlement to depletion deductions. Moreover, what the Court has done today is to mischaracterize a straightforward transaction, the tax consequences of which were clearly and correctly stated in Rev. Rul. 80-48, 1980-1 C.B. 99, and to open the door to the possible distortion of the tax consequences of all transactions involving natural resources.

NIMS, *J.*, agrees with this dissent.

WILLIAMS, *J.*, dissenting: The crux of this case is whether OG & E has an economic interest in the gas *in place*. I submit that it does not. At most, OG & E has secured for itself the economic advantage of a long term, stable supply of gas. As a consumer and not as an investor, it has prepaid for future deliveries to maintain both

[1] The record is silent with regard to OG & E's actual treatment of the payments. However, the majority opinion would preclude OG & E from deducting the payments to petitioners, and would require OG & E to report imputed interest on the amount treated as a loan. See sec. 1.636-1(a), Income Tax Regs.

that supply and its good relations with the supplier. OG & E has the right to command delivery to itself of any gas, *once extracted*, that meets certain specifications of the contract. In my view, that contractual right does not constitute an economic interest in the gas in place notwithstanding that OG & E might well take all of the gas extracted.

In *Palmer v. Bender*, 287 U.S. 551 (1933), the Supreme Court, faced with defining a depletable interest in minerals, stated as follows:

> The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, *by investment, any interest in the oil in place*, and secured, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital. [Emphasis added] 287 U.S. at 557.

This language means that (a) the taxpayer must have a legal right to the mineral in the ground, (b) that right must be acquired by investment, and (c) a return of the taxpayer's investment must be realized out of income to be derived from extracting the mineral. See also, section 1.611-1(b)(1), Income Tax Regs.

In this case, OG & E has no legal right to the mineral in the ground; the contract provides that OG & E's legal ownership commences at the point of delivery (i.e., "the wellhead or the outlet of the well separator, if any "). OG & E has prepaid for a quantity of extracted gas that must be delivered to it in accordance with certain quality specifications and at a given pressure. Under the contract if the gas fails to meet quality specifications (e.g. maximum sulfur content), the parties will adjust the price or,

failing adequate adjustment, OG & E can exclude such gas from the contract. If the gas fails to meet the pressure specification, section 5.4 of the contract provides that unless either OG & E or the petitioners elect to install the equipment necessary to compress the gas to the acceptable pressure, " . . . the Buyer [OG & E] shall, on request of Seller [petitioners] release the production from any such well, together with the acreage attributable thereto, from the provisions of this agreement." It seems to me that in either circumstance (failure of quality or pressure), OG & E has no interest in the gas in place and no right to any income from the sale of such gas. Further, if production from the well is released, it is unclear whether OG & E can recover any prepayment for the gas or whether the sellers must make up deficient deliveries from other wells.[1] On this basis I believe that OG & E has not invested in this well, but has only prepaid for a commodity to be delivered to it. OG & E's right to the gas begins at the metering station on the pipeline and not in the well.

Furthermore, the price that OG & E pays for the gas is itself a strong indicator that OG & E has not invested in

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[1] The contract is silent. Bearing the risk of such loss (assuming that deficient deliveries are not made up as a business practice), however, can make economic sense. The economic advantage of a stable long-term supply may be worth losing the prepayment, e.g., where the cost of securing the supply on the spot market is higher than the price of long-term supply under the contract (including any forfeited prepayments). The record is apparently barren on this point, and I offer the observation only to counter any speculation that the prepayment must necessarily be an "investment" simply because OG & E in fact paid for gas in 1979 that was not delivered to it.

the gas well and does not look to its extraction to recover any "investment." The contract price for the gas is determined by reference to the market price paid by OG & E to other contract suppliers of gas of similar quality and pressure from similar formations and locations in identified counties. In general terms, this formula price can be said to reflect the local market price at the wellhead of a particular quality of gas at a given pressure. If the formula works as contemplated it should produce a price that is, within tolerable limits of deviation, the fair market value of such gas after extraction. OG & E is not, therefore, in a position to profit from any resale of this gas at the wellhead. Consequently, OG & E is not seeking a return from extracting the gas; rather, it is a consumer buying a supply of the commodity it consumes.

Finally, section 3.1 of the contract provides that the quantity of the gas to be delivered under the contract is the *lesser of* (a) 80% of the well's "deliverability" or (b) "80% of the volume of gas made available by Seller to Buyer." This provision seems to me to undercut the majority's view that "deliverability" and "production" are equivalent terms notwithstanding the seller's obligation under section 2.2 of the contract to operate the wells so that they " . . . will deliver gas into Buyer's pipeline when desired by Buyer at the maximum rate at which said wells are capable of production. . . ."

In summary, this agreement is nothing more than a long term supply contract that gives OG & E some assurance that a relatively stable source of natural gas can be delivered to its pipeline according to its specifications when its needs dictate.

NIMS, JACOBS, and PARR, JJ., agree with this dissent.

Supreme Court, U.S.
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No. 88-1789

In the Supreme Court of the United States

OCTOBER TERM, 1989

H. J. FREEDE AND JOSEPHINE W. FREEDE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether a payment received by petitioners under a "take or pay" gas purchase contract for gas not taken was excludable from their gross income as a production payment within the meaning of Section 636(a) of the Internal Revenue Code.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	2
Argument	5
Conclusion	12

TABLE OF AUTHORITIES

Cases:

Brountas v. *Commissioner*, 692 F.2d 152 (1st Cir. 1982), cert. denied, 462 U.S. 1106 (1983) 7
Burton-Sutton Oil Co. v. *Commissioner*, 328 U.S. 25 (1946) 8
Commissioner v. *Southwest Exploration Co.*, 350 U.S. 308 (1956) 6-7
Helvering v. *Bankline Oil Co.*, 303 U.S. 362 (1938) 10, 11
Kirby Petroleum Co. v. *Commissioner*, 326 U.S. 599 (1946) 8
Palmer v. *Bender*, 287 U.S. 551 (1933) 5, 6, 9
Paragon Jewel Coal Co. v. *Commissioner*, 380 U.S. 624 (1965) 10
SEC v. *Howey Co.*, 328 U.S. 293 (1946) 9
Transcontinental Gas Pipe Line Corp. v. *State Oil & Gas Board*, 474 U.S. 409 (1986) 10
United States v. *Swank*, 451 U.S. 571 (1981) 6
United States v. *White*, 401 F.2d 610 (10th Cir. 1968) 6

Statutes and regulation:

Internal Revenue Code of 1954, 26 U.S.C. (1976):
§ 611 6
§ 636 ..... 3, 5, 6, 7
§ 636(a) 3, 10
Treas. Reg.: § 1.636-3(a)(1) 3, 4

Miscellaneous: Page

H.R. Rep. No. 413, 91st Cong., 1st Sess. Pt. 1 (1969) 7

Johnson, *Natural Gas Sales Contracts,* 34 Inst. on Oil & Gas L. & Tax'n 83 (1983) 10

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In the Supreme Court of the United States

OCTOBER TERM, 1989

No. 88-1789

H. J. FREEDE AND JOSEPHINE W. FREEDE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-16a) is reported at 864 F.2d 671. The opinion of the Tax Court (Pet. App. 18a-45a) is reported at 86 T.C. 340.

JURISDICTION

The judgment of the court of appeals was entered on November 1, 1988. A petition for rehearing was denied on January 27, 1989 (Pet. App. 16a-17a). The petition for a writ of certiorari was filed on April 27, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner H. J. Freede[1] owns fractional working interests in various oil and gas leases. In 1975, he entered into a contract to sell gas from one of those leases to Oklahoma Gas & Electric Company (OG&E). The contract included a "take or pay" provision that required OG&E to pay for a specified minimum quantity of gas each year, regardless of whether it took physical delivery of the gas. If the amount of gas paid for under the "take or pay" provision exceeded the amount actually taken, OG&E had the right to credit the excess amount against gas taken in excess of the minimum contract quantity for some future year. This right to a credit against gas purchased in excess of the minimum contract quantities in future years was the only way to recoup payments for gas not taken. If such payments were not recouped during the 20-year term of the contract, OG&E would never receive any gas in return for the excess payments, or any refund. Pet. App. 3a, 20a-22a.

In 1979, OG&E made the minimum payment required by the contract, but took less than the minimum contract quantity. OG&E paid petitioner H. J. Freede a total amount of $462,881 in 1979; most of that amount ($343,255) was paid because of the contractual requirement and represented an advance payment for gas not actually taken in that year. The amount of gas paid for but not taken was available to be credited against gas taken in future years. Pet. App. 3a-4a, 23a-24a.

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[1] Petitioner Josephine W. Freede is a party solely by virtue of having filed a joint income tax return with her husband for the year in issue (Pet. App. 2a & n.1). This case was consolidated in the Tax Court and in the court of appeals with a case involving the income tax liability of Roger S. Folsom and Mary M. Folsom, who also received payments under a "take or pay" contract for gas not taken. The Folsoms did not file a petition for a writ of certiorari.

On their 1979 income tax return, petitioners did not report as income the $343,255 received for gas not taken (Pet. App. 4a, 24a). They took the position that the excess payment created a "production payment" in this amount in favor of OG&E. A "production payment" is a right to a specified share of production for a limited time from a specified mineral property, when production occurs. Under Section 636(a) of the Internal Revenue Code,[2] a production payment carved out of mineral property is treated for tax purposes as if it were a mortgage loan on the property. Petitioners contended that the excess payment therefore should be treated as a loan to them from OG&E, with income recognized only when the gas is actually delivered in subsequent years. The Commissioner determined, however, that the excess payment did not create a production payment within the meaning of Section 636 because OG&E had no economic interest in the gas in place; he therefore concluded that petitioners were required to include the full $462,881 received from OG&E in 1979 in their income for that year.

2. Petitioners sought redetermination of the resulting deficiency in the Tax Court, which ruled in their favor in an 11-4 reviewed decision (Pet. App. 18a-36a). The majority concluded (*id.* at 28a-34a) that all of the criteria set forth in Treas. Reg. § 1.636-3(a)(1) (*reprinted at* Pet. App. 26a) for determining when an arrangement is a "production payment" within the meaning of Section 636(a) were satisfied here. The principal disagreement between the parties concerned one of the criteria—whether OG&E's right to apply the excess payment to future gas purchases was "an economic interest in [the] mineral in place"

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[2] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect for 1979, the taxable year in issue.

(Treas. Reg. § 1.636-3(a)(1)). The majority found that OG&E's interest in the gas "rises to the level of an economic interest, due to the contractual rights and obligations of OG & E" (Pet. App. 32a). The majority relied on the contractual provision that gave OG&E the right to require the producer to maintain certain production levels, stating that the contract therefore gave OG&E "both rights to the minerals in place and a means of controlling production" (*ibid.*).

Four judges dissented in three separate opinions. Judge Nims, in an opinion joined by all the dissenters (Pet. App. 37a-41a), stated that OG&E did not acquire by investment a depletable interest in the mineral in place. Instead, he concluded that OG&E was "simply buying petitioners' gas at the wellhead, not mineral in place" (*id.* at 39a). Judge Williams, in an opinion also joined by all the dissenters (*id.* at 42a-45a), explained that OG&E did not have the requisite economic interest because it "has no legal right to the mineral in the ground" and it "is not seeking a return from extracting the gas" (*id.* at 43a, 45a). He pointed out that OG&E had the right to reject delivered gas that did not meet certain quality specifications and that the price it paid for the gas was determined by the market price after extraction (*id.* at 43a-45a). Thus, he stated that the "take or pay" contract was "nothing more than a long term supply contract that gives OG & E some assurance that a relatively stable source of natural gas can be delivered to its pipeline according to its specifications when its needs dictate" (*id.* at 45a). Judge Parr, in an opinion joined by Judge Nims (*id.* at 41a-42a), expressed her concern that the majority had "elevat[ed] a prepaid contractual right to a supply of a mineral to the level of an investment in the mineral in place," which would "open the door to the possible distortion of the tax consequences of all transactions involving natural resources" (*ibid.*).

3. The court of appeals reversed (Pet. App. 1a-16a). Citing *Palmer* v. *Bender,* 287 U.S. 551 (1933), the court observed that an interest in minerals constitutes an economic interest that can give rise to treatment under Section 636 if a two-pronged test is met: "(1) there must be an interest, acquired by capital investment, in the minerals in place; and (2) the return on the investment must be realized solely from the extraction of the minerals" (Pet. App. 6a-7a). The court declined to decide whether the first prong of the economic interest test was met, finding that an analysis of several relevant factors led to no clear conclusion (*id.* at 7a-13a). The court rested its decision on the second prong of the test, concluding that OG&E did not look to income derived solely from extraction of the gas for the return of its investment (*id.* at 13a-16a). The court stated that OG&E was "not an investor seeking profit from gas extraction," because its "profit is derived solely from the remarketing of the gas to its customers downstream from production, and not from production itself" (*id.* at 15a). In other words, "OG&E's interest is merely that of a consumer paying for gas it receives at the wellhead, not an investor looking for profit from successful extraction" (*id.* at 13a). Having concluded that OG&E did not have an economic interest in the mineral in place, the court held that the excess payment did not create a production payment and therefore was includable in petitioners' gross income (*id.* at 16a).

ARGUMENT

The court of appeals correctly held that OG&E's excess payment under its "take or pay" contract did not create a production payment within the meaning of Section 636 of the Code. That decision is fully consistent with the decisions of this Court, and it does not conflict with any deci-

sion of another court of appeals. Indeed, petitioners candidly acknowledge (Pet. 16) that the question presented here is one of first impression. Accordingly, there is no reason for review by this Court.

1. Petitioners do not dispute that the court of appeals applied the correct legal framework in determining whether the excess payment that they received from OG&E created a "production payment" covered by Section 636. Specifically, petitioners agree that, in order to constitute a production payment, OG&E's right to future production must be an "economic interest" in the mineral in place (see Pet. App. 4a-5a).[3] Petitioners also agree that the inquiry into the existence of an economic interest in the minerals in place is framed by *Palmer* v. *Bender*, 287 U.S. 551 (1933), where this Court stated that a taxpayer has such an interest if he "has acquired, by investment, any interest in the oil [or other mineral] in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital" (*id.* at 557). As this Court subsequently explained, *Palmer* sets forth two requirements for demonstrating the existence of an economic interest: the taxpayer must (1) acquire, by investment, an interest in the mineral in place; and (2) look solely to income derived from extraction of the mineral for the return of his investment. *Commissioner* v. *Southwest Exploration Co.*, 350 U.S.

[3] The "economic interest" concept is fundamental in determining the tax consequences of transactions involving mineral properties, and it has other specific applications in this area. For example, depletion deductions under Section 611 of the Code are allowed only to a holder of an economic interest in the mineral property. See *United States* v. *Swank*, 451 U.S. 571, 572, 579-580 (1981). The economic interest concept is also used to determine whether a transaction is a sale or a lease. See *United States* v. *White*, 401 F.2d 610, 613 (10th Cir. 1968) (en banc).

308, 313-314 (1956). See generally Pet. 7-11. Petitioners object only to the application of those established rules of law to the facts of this case. Their contentions are without merit and, if accepted, would permit the use of Section 636 to obtain a windfall tax benefit (in the form of deferral of income actually received) not intended by Congress.[4]

The court of appeals correctly concluded that OG&E did not look to income derived solely from extraction of the gas for the return of any investment and that it therefore failed the second prong of the *Palmer* test (Pet. App. 13a-15a).[5] This Court has stated that it is the taxpayer's " 'possibility of profit' from the use of his rights over pro-

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[4] Section 636 was added to the Code in 1969 to close what was seen as a loophole that permitted owners of mineral properties to secure certain unjustified tax advantages by creating production payments. Under prior law, taxpayers had been able to use production payment transactions to avoid certain limitations on tax benefits – namely, the 50% limitation on taxable income from the property for percentage depletion purposes, the foreign tax credit limitation, the five-year net operating loss carryover limitation, and the seven-year investment credit carryover limitation. Moreover, by using production payments as part of a broader transaction, taxpayers were able to use "pre-tax" dollars to repay what was, in effect, a loan. It was to prevent these abuses that Congress provided in Section 636 that production payment transactions would generally be treated as loan transactions. H.R. Rep. No. 413, 91st Cong., 1st Sess. Pt. 1, at 139-141 (1969); S. Rep. No. 552, 91st Cong., 1st Sess. 183-184 (1969); see *Brountas* v. *Commissioner*, 692 F.2d 152, 159-160 (1st Cir. 1982), cert. denied, 462 U.S. 1106 (1983).

[5] Although it discussed the factors relevant to the question whether the first prong of the test was satisfied, the court of appeals ultimately concluded that its analysis led to no clear conclusion on that point, and it expressly declined to decide whether the first prong was satisfied. See Pet. App. 8a-13a. Accordingly, petitioners' argument that the court's discussion of the first prong of the test is inconsistent with this Court's precedent (see Pet. 13-15) is irrelevant and provides no basis for review of the decision below.

duction, 'dependent solely upon the extraction and sale of the oil,' which marks an economic interest in the oil." *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U.S. 25, 34-35 (1946) (quoting *Kirby Petroleum Co.* v. *Commissioner,* 326 U.S. 599, 604 (1946)). As the court of appeals observed (Pet. App. 15a), however, in making the minimum payments required by the "take or pay" contract, OG&E is "not an investor seeking profit from gas production;" it is a purchaser making advance payments for future deliveries of the commodity it purchases. An investor who seeks a return from extraction of gas (*i.e.,* from his interest in the mineral in place) hopes that the production costs he incurs will be less than the price for which the gas can be sold at the wellhead after extraction. OG&E has no such interest in the relationship between production costs and the price at the wellhead. As noted in Judge Williams' dissenting opinion in the Tax Court (*id.* at 45a), the gas purchase contract here provided that OG&E would pay the market price for the gas at the wellhead. Moreover, OG&E would receive no income whatever from any sale of gas by the producers to a third party. OG&E thus is like any other utility that purchases gas from producers; it makes its profits from remarketing the gas to its customers, not from gas production. Since OG&E is not seeking to profit from extraction, the claim that the excess payment created a production payment fails the second prong of the *Palmer* test.

Petitioners contend (Pet. 11-12) that the court of appeals misapplied *Palmer* because the requirement of an "investment" in minerals in place can be satisfied if the "investor" expects a return of capital, even if there is no possibility of a profit from extraction. This Court clearly stated, however, in *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U.S. at 34-35, and *Kirby Petroleum Co.* v. *Commissioner,* 326 U.S. at 604, that the "possibility of

profit" from extraction marks an economic interest. These cases follow *Palmer* and do not purport to deviate from its rule; hence, there is no reason to ignore these decisions and hold that one who has no expectation of profit from extraction can be viewed as having an economic interest in minerals in place.[6] Moreover, the Court in *Palmer* itself stated that an economic interest requires the acquisition "by investment" of an interest in the mineral. 287 U.S. at 557. The intent to make a profit is inherent in the concept of an "investment." The disposition of money under circumstances in which a mere return of capital with zero profit is the best possible outcome—for example, stuffing one's money into a mattress—is not ordinarily regarded as an "investment." See *SEC* v. *Howey Co.*, 328 U.S. 293, 298-299 (1946) (an "investment contract" for purposes of the securities laws means "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party").

The excess payments made by OG&E under the "take or pay" provision are simply one feature of a long-term supply contract. OG&E did not agree to that provision because it wanted to invest in gas in place. Rather, OG&E prepaid for future deliveries in order to maintain good relations with the supplier and a long-term, stable supply of gas. The purpose of a "take or pay" contract, from the purchaser's viewpoint, is to provide flexibility in the event of uneven demand and to maintain stable relationships

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[6] There is no merit to petitioners' argument (Pet. 12) that *Burton-Sutton Oil* and *Kirby Petroleum* are inapposite here because in both cases the question was whether the taxpayer was entitled to depletion deductions. *Palmer* also involved a depletion question. The "economic interest" issue arose in all three cases because depletion deductions are allowed only to a holder of an economic interest in the mineral property, and all three cases are equally applicable here. See note 3, *supra*.

with producers. See Johnson, *Natural Gas Sales Contracts,* 34 Inst. on Oil & Gas L. & Tax'n 83, 111 (1983); Pierce, *Natural Gas Regulation, Deregulation, and Contracts,* 68 Va. L. Rev. 63, 68-69 (1982). A "take or pay" contract also enables a seller to avoid fluctuations in cash flow by assuring a minimum annual return. See *Transcontinental Gas Pipe Line Corp.* v. *State Oil & Gas Board,* 474 U.S. 409, 412 (1986); Johnson, *supra,* 34 Inst. on Oil & Gas L. & Tax'n at 111; 4 H. Williams, *Oil and Gas Law* § 724.5, at 659 (1988). The excess payments were intended to, and did, give OG&E a prepaid contractual right to a supply of gas, not an economic interest in the gas in place.[7]

3. Petitioners contend (Pet. 7-11) that the court of appeals' decision is inconsistent with this Court's decisions in *Helvering* v. *Bankline Oil Co.,* 303 U.S. 362 (1938), and *Paragon Jewel Coal Co.* v. *Commissioner,* 380 U.S. 624 (1965). This contention is without merit. Indeed, *Bankline* strongly supports the decision below, as the court of appeals recognized in stating that "*Bankline* compels reversal [of the Tax Court's decision] here" (Pet. App. 14a).

As the court of appeals explained (Pet. App. 14a), OG&E was in the same posture as the purchaser-taxpayer

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[7] Petitioners err in asserting (Pet. 10) that the Commissioner's position in this case is contrary to his published ruling position. As the Tax Court noted (Pet. App. 34a-36a), Rev. Rul. 80-48, 1980-1 C.B. 99, sets forth the Commissioner's position that a "take or pay" gas purchase contract does not give the purchaser an economic interest in gas in place and, therefore, that Section 636(a) does not operate to exclude from the seller's gross income payments for gas not taken. Petitioners cite (Pet. 10) Rev. Rul. 66-64, 1966-1 C.B. 97, but that ruling merely holds that the purchaser of gas under a "take or pay" contract is not entitled to a current deduction for amounts paid for gas not taken. The ruling does not state or suggest that the purchaser has an economic interest in that gas in place.

in *Bankline.* The taxpayer there was a gas processor that contracted with gas producers to buy wet gas at the well-head, which it then processed into gasoline and dry gas. The Court held that, although the taxpayer "through its contracts obtained an economic advantage from the production of the gas," the taxpayer had "no interest in the gas in place." 303 U.S. at 368. The facts relied upon by the Court in concluding that the taxpayer had no interest in the gas in place are similar to the facts of the instant case (*id.* at 367-368):

> Respondent [the taxpayer] is a processor. It was not engaged in production. Under its contracts with gas producers, respondent was entitled to a delivery of the gas produced at the wells, and to extract gasoline therefrom, and was bound to pay to the producers the stipulated amounts. * * * [T]he gas was to be delivered to respondent at the casingheads or gas traps installed by the producer. Respondent had the right to have the gas delivered, but did not produce it and could not compel its production.

Like the taxpayer in *Bankline Oil,* OG&E was merely a purchaser of gas that had no interest in the gas in place. OG&E's right to offset payments for gas not taken against gas taken in future years was simply a contractual right that gave it an economic advantage from the production of gas.

Petitioners argue (Pet. 8) that this case is distinguishable from *Bankline* and *Paragon* because OG&E bore a risk of loss if the well developed problems and could no longer produce, since the excess payments then could not be recouped. This factual difference, however, plainly does not make the decision below inconsistent with *Bankline* and *Paragon.* Neither of those decisions suggested that risk of loss was determinative of the economic interest question;

indeed, neither decision even discussed risk of loss. Hence, there is no conflict between the decision below and any decision of this Court.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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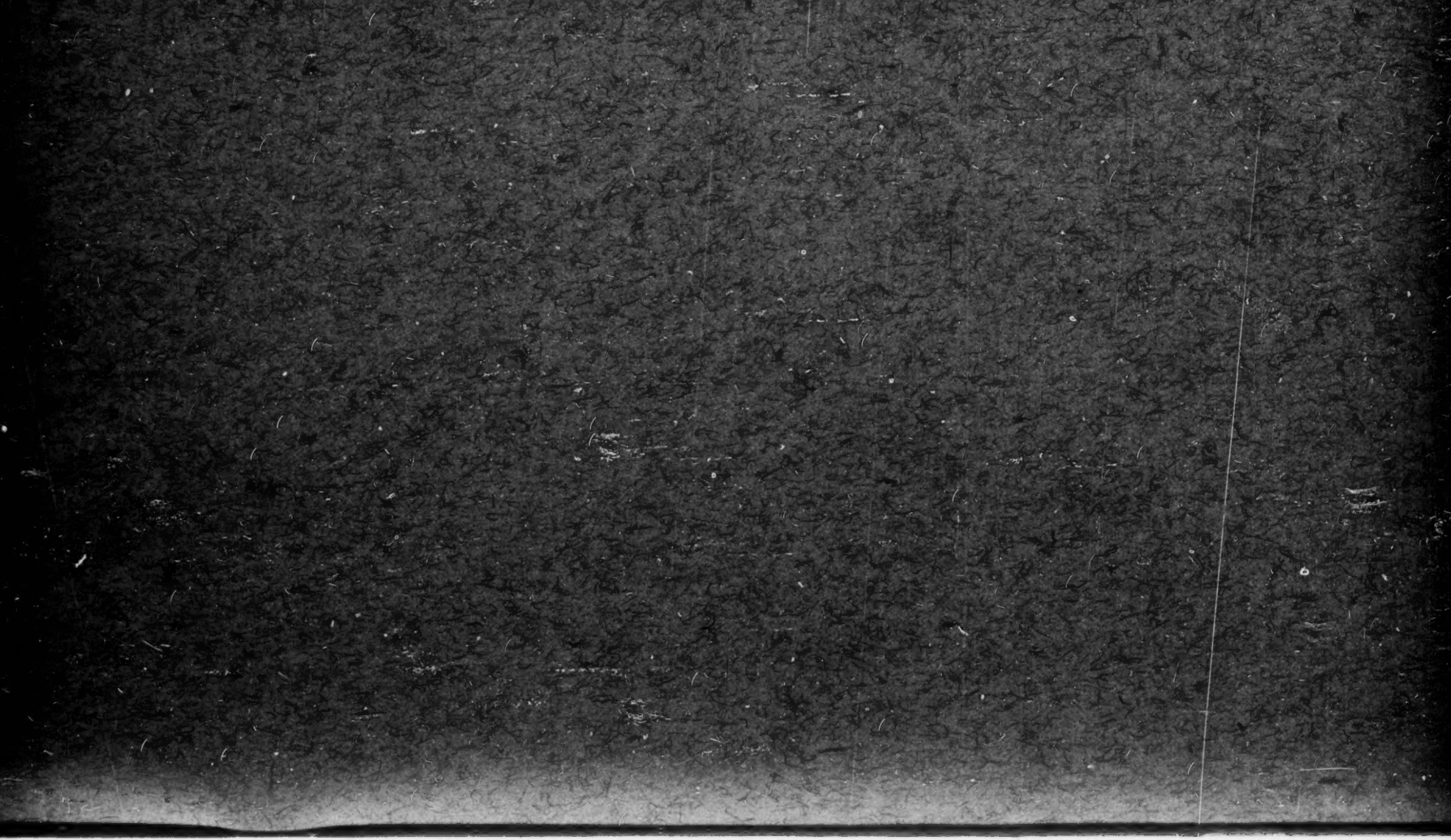

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Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition For Writ Of Certiorari To The United States Court of Appeals For The Tenth Circuit

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QUESTION PRESENTED

Whether amounts paid under a take-or-pay contract by a natural gas purchaser constitute "production payments" within the meaning of Section 636(a) of the Internal Revenue Code?

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
TABLE OF AUTHORITIES	iii
INTEREST OF THE AMICUS CURIAE	1
ARGUMENT	3
I. The Magnitude Of This Issue And Its Recurrence Throughout The Natural Gas Industry Makes Imperative This Court's Review	3
II. The Tenth Circuit's Conclusion That Section 636 Of The Internal Revenue Code Does Not Apply To Take-or-Pay Payments Contradicts Congressional Intent	6
III. The Tenth Circuit's Test For Application Of Section 636 Of The Internal Revenue Code And The Regulations Of The Internal Revenue Service Thereunder Are Inconsistent, Resulting In Conflicting Sources Of Law	11
CONCLUSION	14

TABLE OF AUTHORITIES

CASES	Page
Alabama ex rel. Graddick v. Tennessee Valley Authority, 636 F.2d 1061 (5th Cir. 1981), *cert. denied*, 454 U.S. 837 (1981)	11
Chevron U.S.A. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984)	13,14
C.I.R. v. P.G. Lake, 356 U.S. 260 (1958)	7
Diamond Shamrock Exploration Co. v. Hodel, 853 F.2d 1159, (5th Cir. 1988)	5
Freede v. Commissioner, 86 T.C. 340 (1986)	2
H.J. Freede v. Commissioner of Internal Revenue, 864 F.2d 671 (10th Cir. 1988)	1
Louisiana Power & Light Co. v. United States Gas Pipe Line Co., 456 F.2d 326 (5th Cir. 1972) *rev'd. on other grounds*, 453 U.S. 923 (1972)	11
PGC Pipeline v. Louisiana Intrastate Gas, 791 F.2d 338, (5th Cir. 1986)	5
Transcontinental Gas Pipe Line Corp. v. State Oil & Gas Bd. of Mississippi, 474 U.S. 409 (1986)	4
United States v. Nixon, 418 U.S. 683 (1974)	13
Universal Resources Corp. v. Panhandle Eastern Pipe Line Co., 813 F.2d 77 (5th Cir. 1987)	5

STATUTES AND RULES	
I.R.C. § 611(a) (1954)	7
I.R.C. § 613(a) (1954)	7
I.R.C. § 613A(d) (1975)	7
I.R.C. § 613A(d)(5) (1986)	10
I.R.C. § 636 (1969)	*passim*
Treas. Reg. § 1.613-3(a) (1960)	7,8
Treas. Reg. § 1.613-3(b) (1960)	7

Table of Authorities Continued

Page

Treas. Reg. § 1.636-1(a)(3) (1973) 11,12

Treas. Reg. § 1.636-3(a) (1973) 12

Rev. Rul. 80-48, 1980-1 C.B. 99 6

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Polevoi and Smith, *Federal Taxation of Oil and Gas Transactions*, § 9.07 (1988) 8

Russell and Bowhay, *Income Taxation of Natural Resources*, Ch. 8.01 (1988) 7,8

IN THE

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COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Tenth Circuit

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BRIEF *AMICUS CURIAE* OF THE AMERICAN PETROLEUM INSTITUTE

INTEREST OF THE AMICUS CURIAE

The American Petroleum Institute ("API") submits this brief with the consent of the parties as *amicus curiae* in support of the petition for writ of certiorari in No. 88-1789. The petition seeks review of a judgment of the United States Court of Appeals for the Tenth Circuit. *H.J. Freede v. Commissioner of Internal Revenue*, 864 F.2d 671 (10th Cir. 1988). That court reversed the decision of the United States Tax Court which ruled in favor of the taxpayer-petitioners, holding that payments received under a take-or-pay

natural gas supply contract constituted "production payments" under § 636 of the Internal Revenue Code, to be treated as nontaxable loans rather than ordinary income when they were received. *Freede v. Commissioner*, 86 T.C. 340 (1986).

In this case, the Internal Revenue Service ("IRS") contends that take-or-pay payments made to petitioners by Oklahoma Gas & Electric ("OG & E") are includable in petitioners' income in the year received. Petitioners argue that these payments constitute "production payments" under I.R.C. § 636(a) and thus are treated as mortgage loans for federal income tax purposes. API supports the petitioners' position that a producer who receives a take-or-pay payment realizes income from the sale of gas, not in the year in which the payment is received, but only in the year in which make-up production of gas occurs, *i.e.*, the year in which the purchaser recoups its loan through the purchase of the make-up gas under the take-or-pay contract or when the recoupment period expires. Take-or-pay payments are economically equivalent to a loan from the purchaser to the producer to be repaid with production. Thus, take-or-pay payments, like the proceeds of any other loan, do not constitute income when received by the producer. API is confident that plenary review by this Court would rectify the errors made by the Tenth Circuit in the decision below, precluding an inevitable conflict between the circuit courts and resolving properly the tax treatment of take-or-pay payments. This case presents an opportunity for this Court to further clarify the statutory meaning of a "production payment," a fundamental concept of mineral taxation which, in the

context of take-or-pay contracts, will resolve the proper tax treatment of billions of dollars.

API is a national trade association with over 200 company members which represents all facets of the petroleum industry: exploration, production, transportation, refining, and marketing. The vital interest of API's members in this case is that of taxpayers who are similarly situated to the petitioners in this case. Members of API include producers of natural gas who are parties to gas purchase contracts with take-or-pay provisions similar to the provisions involved in this case. API routinely participates on the petroleum industry's behalf in legislative, administrative, and judicial proceedings when issues of national significance are presented. This case presents such an issue.

REASONS FOR GRANTING THE WRIT

I. The Magnitude of This Issue And Its Recurrence Throughout The Natural Gas Industry Makes Imperative This Court's Review.

According to the Interstate Natural Gas Association of America (INGAA), from 1982-1987, interstate natural gas pipelines have incurred take-or-pay exposure of $21.8 billion.[1] Consequently, purchasers have made and will continue to make enormous payments to gas producers pursuant to take-or-pay contracts that are no different from that presented in the case at bar. In fact, the take-or-pay provision in the contract between petitioner and OG & E is typical of those commonly used in the industry throughout the 1970's and early 1980's. These clauses were standard provisions

[1] *See*, "A Comparison of the INGAA and NGSA 1988 Take-or-Pay Analyses," INGAA, 88-6, May 1988, p. 5, Table 2.

in virtually all gas purchase contracts between producers and purchasers entered into during that time. The use of these provisions grew out of the regulatory environment which has governed the natural gas industry until just recently. This regulation of the industry created artificial shortages of gas; in response to these shortages, take-or-pay provisions were uniformly negotiated as the *quid pro quo* for the producers' exclusive commitment of gas reserves to a purchaser. The partial deregulation of natural gas in the 1980's has produced a market where gas has been plentiful and gas purchasers have incurred enormous take-or-pay obligations as a result.

Take-or-pay provisions have historically been viewed as providing benefits to both natural gas producers and purchasers. Producers were benefitted by the assured cash flow provided by these clauses which enabled both large and small producers to finance the large initial expenditures needed to develop gas properties and also to bear the steady operating costs associated with producing gas. Without an assured cash flow for their product, many producers would have been financially unable to develop their gas properties. From the standpoint of the gas purchasers, these take-or-pay provisions insured them a supply of gas in a market where gas was in short supply.

Many court rulings, including dicta from this Court, have acknowledged the essential contribution a purchaser makes to the development and operation of a mineral property when it executes a take-or-pay contract. Thus, this Court observed recently in *Transcontinental Gas Pipe Line Corp. v. State Oil and Gas Board of Mississippi*, 474 U.S. 409 (1986):

> Take-or-pay provisions enable sellers to avoid fluctuations in cash flow and are therefore thought to encourage investment in well development. *Id.* at 412.

In addition, in *Universal Resources Corp. v. Panhandle Eastern Pipe Line Co.*, 813 F.2d 77 (5th Cir. 1987), the Court of Appeals for the Fifth Circuit analyzed take-or-pay contract clauses and recently found:

> *The purpose of the take-or-pay clause is to apportion the risks of natural gas production and sales between the buyer and seller.* The seller bears the risk of production. To compensate the seller for that risk, the buyer agrees to take, or pay for if not taken, a minimum quantity of gas. *The buyer bears the risk of market demand.* The take-or-pay clause insures that if the demand for gas goes down, seller will still receive the price for the Contract Quantity delivered each year. *Id.* at 80. (emphasis added).

The Fifth Circuit further expounded upon the nature of take-or-pay contracts in a later decision, observing that "the take-or-pay obligation ensures to the producer a continuous source of revenue to cover investment, operations, and maintenance." *Diamond Shamrock Exploration Co. v. Hodel*, 853 F.2d 1159, 1167 (5th Cir. 1988). Succinctly, the Fifth Circuit has noted that "[t]he take-or-pay option is commonly given in gas contracts because of the cyclical nature of the demand for gas." *PGC Pipeline v. Louisiana Intrastate Gas*, 791 F.2d 338, 341 (5th Cir. 1986).

Payments made under these take-or-pay contracts have created a question as to their proper tax treat-

ment. As evidenced by this case, the proper characterization of the interests created by the payments from OG & E to petitioners remains unresolved. The IRS has indicated its position in Rev. Rul. 80-48, 1980-1 C.B. 99 that these payments are taxable income to the producer. On the other hand, commentators generally agree that these payments warrant characterization as production payments under I.R.C. § 636 which are treated for federal income tax purposes as mortgage loans.[2] Given the magnitude of the issue and its recurrence throughout the natural gas industry, it is imperative that this issue be addressed. In the interest of the orderly and efficient administration of the tax laws, this issue needs to be finally settled. If this Court does not grant certiorari in this case, this issue is certain to be litigated in other circuits. It is quite likely that another circuit, presented with this identical issue, would reach a conclusion which would conflict with that of the Tenth Circuit below. Rather than awaiting that inevitable conflict, the magnitude of this issue to natural gas producers warrants its resolution by this Court at this time.

II. The Tenth Circuit's Conclusion That Section 636 Of The Internal Revenue Code Does Not Apply To Take-or-Pay Payments Contradicts Congressional Intent.

The extraction of minerals from their natural reservoir and their eventual exhaustion results in a physical depletion of the mineral deposit. This physical depletion of a mineral deposit necessarily reflects an

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[2] *See, e.g.*, Burke and Karpen, "New Revenue Ruling 80-48: A Blueprint for Recreating Carved-Out Production Payments?" 53 J. Tax'n 370 (1980); Linden, "Significant Current Developments in Oil and Gas Taxation," 38th Ann. Inst. on Oil & Gas L. & Taxation § 11.06 (1987).

economic depletion of its value.[3] In recognition of the depleting value of a mineral deposit, the Internal Revenue Code has since 1926 provided producers "a reasonable allowance for depletion" of "oil and gas wells [and] other natural deposits." I.R.C. § 611(a). For certain producers, this allowance is computed as a specified percentage "of the gross income from the property" (percentage depletion). I.R.C. § 613(a). "Gross income from the property" for oil and gas wells is defined as the "amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well." Treas. Reg. § 1.613-3(a) (1960). "Gross income from the property" for minerals other than oil and gas is defined as "gross income from mining." Treas. Reg. § 1.613-3(b) (1960). The allowance for percentage depletion under I.R.C. § 613(a), however, is limited to "50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion)." I.R.C. § 613(a). With respect to oil and gas wells, an additional limitation on percentage depletion of "65 percent of the taxpayer's taxable income for the year" was enacted in 1975. I.R.C. § 613A(d).[4]

In *C.I.R. v. P.G. Lake*, 356 U.S. 260 (1958), this Court held that a producer who sells a carved-out

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[3] Russell and Bowhay, *Income Taxation of Natural Resources*, Ch. 8.01, 1988 ed.

[4] I.R.C. § 613A was enacted by the Tax Reduction Act of 1975, Pub. L. No. 94-12, § 501(a), 89 Stat. 26 (1975). Under § 613A, percentage depletion on oil and gas wells is repealed for some producers on most wells. However, certain gas wells and producers are exempted from the repeal. I.R.C. §§ 613A(b) and (c). For those producers still entitled to percentage depletion, a new limitation based on the taxpayer's taxable income was added. I.R.C. § 613A(d).

production payment[5] receives "gross income from the property" for percentage depletion purposes. As a result of the decision in *P.G. Lake*, many taxpayers engaged in transactions designed to minimize the income limitations on percentage depletion. Producers would assign to a third party, in exchange for cash, the right to a share of the future production from a property, i.e., a carved-out production payment. By assigning the right to share in future production, a producer was then able to include the cash received in his "gross income from the property" for percentage depletion purposes pursuant to *P.G. Lake*, *supra*. Moreover, since the production, and therefore related expenses, had not yet occurred, the producers were able to increase their total percentage depletion deductions by increasing "taxable income from the property," thus minimizing the net income limitations of I.R.C. § 613(a), *supra*. Furthermore, by shifting the future income stream from sale of the production to the purchaser of the production payment, the producer was not liable for taxes on that income if and when production occurred.

In response to the use of carved-out production payments to minimize the limitations on percentage depletion, Congress enacted I.R.C. § 636 in 1969. Tax Reform Act of 1969, Pub. L. No. 91-172, § 503, 83

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[5] A production payment is the right to share in the production of a mineral in place, where such right is limited by a dollar amount, a quantum of mineral, or a period of time. Treas. Reg. § 1.636-3(a), Polevoi and Smith, *Federal Taxation of Oil and Gas Transactions*, § 9.07; Russell and Bowhay, *Income Taxation of Natural Resources*, Ch. 2.07, 1988 ed. A carved-out production payment is one purchased from a larger interest in the mineral deposit.

Stat. 487 (1969). The Committee reports clearly state that this was Congress' primary intention in enacting I.R.C. § 636:

> In the case of the carved-out payments, by the advancing of the time income (but not related expense) is reported for tax purposes, taxpayers have been able to avoid limitations based on net or taxable income—principally the 50-percent limitation on taxable income from the property for percentage depletion purposes. . .

S. Rep. No. 552, 91st Cong., 1st Sess. Pt. 1, at 183 (1969). Congress found that the payment of cash in exchange for a right to a share of future production was "similar, in fact, to a loan transaction with the loan secured by a mortgage on the property and the 'borrower' not personally liable for the loan." *General Explanation of the Tax Reform Act of 1969*, H.R. 13270, 91st Cong., 1st Sess. (1970) at 169. Therefore, under I.R.C. § 636 the seller of the production payment does not realize "gross income from the property", but instead is treated as receiving a mortgage loan which is repaid from production. I.R.C. § 636(a). "Thus, [under I.R.C. § 636], the use of a carved-out production payment would not cause income to be accelerated, and there would be, thus, no avoidance of the limitation on the percentage depletion deduction." S. Rep. No. 552 at 185, *supra*.

The relevant Committee reports make clear that Congress intended for I.R.C. § 636 to apply to transactions which are economically equivalent to loans where the lender is to be repaid from production, *supra*. Take-or-pay payments fall within this classi-

fication since the producer receives funds in return for his promise to repay the loan with production from the property. If producers could take these payments into "gross income from the property" in the year of receipt for percentage depletion purposes rather than in the year of production, they would "advanc[e] the time income (but not related expense) is reported for tax purposes,. . .[and will be] able to avoid limitations based on net or taxable income. . ." S. Rep. No. 552, *supra*, at 183.[6] This is precisely the tax result Congress intended to foreclose in enacting I.R.C. § 636. Under I.R.C. § 636, income from a take-or-pay payment should be recognized only as production occurs, thereby insuring that percentage depletion is correctly computed and is consistent with the economic reality of actual physical depletion of minerals.

In addition to possible effects on the percentage depletion limitation, Congress also sought at the time of enactment of I.R.C. § 636 to prevent the acceleration of income via carved-out production payments for other tax planning opportunities, such as ". . .the

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[6] At the time I.R.C. § 636 was enacted, an oil and gas producer was entitled to take percentage depletion on take-or-pay payments as well as payments for actual production during the year. However, the Tax Reform Act of 1986 added I.R.C. § 613A(d)(5), which now prevents oil and gas producers from taking percentage depletion on take-or-pay payments or any other payments made without regard to actual production. I.R.C. § 636 prescribes a similar linkage between income recognition and actual production.

It should be noted that I.R.C. § 636 applies to all mineral properties and the potential for avoiding percentage depletion limitations still exists for minerals other than oil and gas.

foreign tax credit limitation, the 5-year net operating loss carry-over limitation, and the 7-year investment credit carry-over." S. Rep. No. 552, *supra* at 183. The Tenth Circuit's decision, however, totally disregards Congress' express intent in enacting I.R.C. § 636, and judicially legislates an exception to its applicability which will allow taxpayers to once again accelerate recognition of income merely by conveying a share of future production.

Obviously, the judgment of the Tenth Circuit regarding the application of I.R.C. § 636 can not permissibly undermine Congress' intent in enacting that section. It is a basic axiom that a statute is to be construed in accordance with Congressional intent at the time of its enactment. *Louisiana Power & Light Co. v. United States Gas Pipe Line Co.*, 456 F.2d 326 (5th Cir. 1972), *rev'd on other grounds*, 453 U.S. 923 (1972); *see also, Alabama ex rel. Graddick v. Tennessee Valley Authority*, 636 F.2d 1061, 1066 (5th Cir. 1981), *cert. denied*, 454 U.S. 837 (1981). API therefore supports this Court's review and reversal of the decision below which fails to implement the will of Congress.

III. The Tenth Circuit's Test For Application Of Section 636 Of The Internal Revenue Code And The Regulations Of The Internal Revenue Service Thereunder Are Inconsistent, Resulting In Conflicting Sources Of Law.

The regulations promulgated pursuant to I.R.C. § 636 provide the following example of a typical "production payment" to illustrate the application of I.R.C. § 636:

> *Example (1).* On December 22, 1972, A, a cash-basis calendar-year taxpayer who owns operating mineral interest X, carves out of

> X a production payment in favor of B for $300,000 plus interest, payable out of 50 percent of the first oil produced and sold from X. In 1972, A treats the $300,000 received from B for the production payment as the proceeds of a mortgage loan on X. . . .

Treas. Reg. § 1.636-1(a)(3)(1973).

The interest created in Example 1 is economically indistinguishable from the interest created under a take-or-pay payment. In both situations, the producer has merely conveyed to the purchaser a right to future production. Neither purchaser has a formal, legal ownership interest in the minerals in place prior to their actual production. Both have made a cash payment to the producer in return for a future share of production. Both look to future production as their only means of recapturing their investment. Both have their share of future production limited by time, a quantum of mineral or an amount of money.

Since the two situations are economically equivalent, the application of I.R.C. § 636 should be consistently applied to each. In fact, the I.R.S. regulations stress the importance of economic realities in applying I.R.C. § 636:

> A right which is in substance economically equivalent to a production payment shall be treated as a production payment for purposes of section 636 and the regulations thereunder, *regardless of the language used to describe such right, the method of creation of such right or the form in which such right is cast.* (emphasis added).

Treas. Reg. § 1.636-3(a)(2) (1973).

Both the Tenth Circuit's analysis and conclusion below conflict with the analysis and result prescribed by the relevant regulations. Specifically, the analysis of the Tenth Circuit regarding the application of I.R.C. § 636 to take-or-pay payments would, if applied to the facts in Example 1 of the regulations, *supra*, render I.R.C. § 636 similarly inapplicable. Thus, the generic "production payment" illustrated in the regulatory example, which is economically equivalent to the take-or-pay payments in question, would not pass muster in the Tenth Circuit. The Tenth Circuit's ultra-restrictive analysis would render I.R.C. § 636 a nullity, *i.e.*, even the illustrative example of its operation contained in the regulations would no longer warrant its application. Moreover, the requirement of economic equivalency does not appear to have been considered, *supra*. This Court should clarify that, as between the law reflected in the regulations and the Tenth's Circuit's theory, the regulations reflect Congressional intent that I.R.C. § 636 be applied expansively to deny the accelerated recognition of income from mineral properties, *supra*.

Finally, in *Chevron U.S.A. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), this Court held that an agency's regulations "are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." 467 U.S. at 844. Despite its position in this case, the Internal Revenue Service is bound by its validly promulgated regulations under I.R.C. § 636, *United States v. Nixon*, 418 U.S. 683, 695-96 (1974), which, if applied in this case, would render that section applicable to take-or-pay payments, *supra*. To the extent those regulations

and the Tenth Circuit's analysis yield inconsistent results, this Court's guidance in *Chevron* should control:

> . . .[A] court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the. . .agency.

467 U.S. at 844.

API respectfully requests that this Court review this case to uphold the vitality of the Service's own regulations and I.R.C. § 636 itself.

CONCLUSION

The petition for a writ of certiorari should be granted in this case to provide needed guidance to taxpayers with respect to the proper tax treatment of billions of dollars of payments being received under take-or-pay purchase contracts similar to the one which is under consideration in this case.

Respectfully submitted,

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